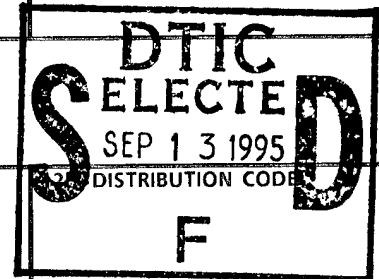


# REPORT DOCUMENTATION PAGE

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The Environmental Cost Principle:  
Gone But Not Forgotten

By

Jeffrey Lee Robb  
B.S., Magna Cum Laude, May 1980, Rio Grande College  
J.D. December 1983, The American University  
M.A. May 1984, The American University

A Thesis Submitted to

The Faculty of

The National Law Center  
of The George Washington University  
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for the degree of Master of Laws

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Thesis directed by  
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## I. INTRODUCTION

I'm from Muskogee, OK[lahoma]. Mr. and Mrs. Smith live on 14th Street in Muskogee, OK. What they are going to read tomorrow about Tucson is this. They are going to read that Hughes Aircraft improperly disposed of hazardous waste [at the Air Force's Plant #44] that they [Hughes] were under contract to dispose of with the Air Force. But the Air Force has decided that they [the Air Force] is [sic] going to pay for it [the cost of the cleanup required as a result of Hughes's improper disposal]. Not only are they going to pay for it, they're going to pay them [Hughes] a profit for cleaning it up. And so, Hughes Aircraft is not [even] being slapped on the wrist, is not being held accountable like Mr. and Mrs. Smith on 14th Street may be if they dump something [hazardous] in their backyard. . . . And what am I going to tell them why there are two sets of standards, one for government contractors and one for the public? What am I going to tell them? What do you want me to tell them?

*Hearing on Hazardous Wastes Problems at  
Department of Defense Facilities Before the  
Subcomm. on Environment, Energy, and  
Natural Resources of the House Comm. on  
Government Operations, 100th Cong., 2d  
Sess. 91 (1987) (statement of Rep. Mike  
Synar)*

The concerns Representative Synar expressed in these comments are quite valid.

The factual basis for them might be better understood, however. The analogy is nevertheless a good one. This thesis examines how the government intends either to pay for or disallow the environmental costs of those with which it does its business, and how this treatment of costs might be different from the treatment experienced by Mr. and Mrs. Smith.

Much stir surrounds a so-called "Draft Environmental Cost Principle," which has not even been published in the Federal Register for comments pursuant to formal rule-making.<sup>1</sup> The environmental cost principle was conceived in a matter of cleanup cost

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<sup>1</sup> The language most commonly associated with the draft cost principle follows. It  
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was published in Federal Contracts Reports (BNA) on May 4, 1992 and has even been given the FAR citation of 31.205-9. *Draft FAR Environmental Cost Principle*, 57 FED. CONT. REP. (BNA) 692 (1992). It provides:

- (a) Environmental costs--
  - (1) Are those costs incurred by a contractor for:
    - (i) The primary purpose of preventing environmental damage; properly disposing of waste generated by business operations; complying with environmental laws and regulations imposed by Federal, State, or local authorities; or
    - (ii) Correcting environmental damage.
  - (2) Do not include any costs resulting from a liability to a third party.
- (b) Environmental costs in paragraph (a)(1)(i) of this subsection, generated by current operations, are allowable, except those resulting from violation of law, regulation, or compliance agreement.
- (c) Environmental costs in paragraph (a)(1)(ii) of the subsection, incurred by the contractor to correct damage caused by its activity or inactivity, or for which it has been administratively or judicially determined to be liable (including where a settlement or consent decree has been issued), are unallowable, except when the contractor demonstrates that it:
  - (1) Was performing a Government contract at the time the conditions requiring correction were created and performance of that contract contributed to the creation of the conditions requiring correction;
  - (2) Was conducting its business prudently at the time the conditions requiring correction were created, in accordance with then-accepted relevant standard industry practices, and in compliance with all then-existing environmental laws, regulations, permits and compliance agreements;
  - (3) Acted promptly to minimize the damage and costs associated with correcting it; and
  - (4) Has exhausted or is diligently pursuing all available legal and contributory (e.g., insurance or indemnification) sources to defray the environmental costs.
- (d) In cases where the current owner is required to correct environmental damage which was caused by the activity or inactivity of a previous owner, user, or other lawful occupant of an affected property, the resulting environmental costs are unallowable, except where the current contractor demonstrated that:
  - (1) The previous owner, user, or other lawful occupant's actions satisfy the criteria in paragraphs (c)(1) through (3) of this subsection and
  - (2) The current contractor has complied with paragraphs (c)(3) and (4) of this subsection during the period that it has owned, used, or occupied the property.
- (e) However, paragraphs (c) and (d) of this subsection do not apply to costs incurred in satisfying specific contractual requirements to correct environmental damage (e.g., where the Government contracts directly for the correction of the environmental damage at a facility which it owns).
- (f) Increased environmental costs resulting from the contractor's failure to obtain all insurance coverage specified in Government contracts are unallowable.

(Continued next page . . .)



allowability under United States Air Force contract management. The concern, like Representative Synar's, was that the government was paying for costs attributable to a contractor's acts in violation of the law or of the exercise of due care. The government feared dangerous precedent that would require it to assume the burden of proving disallowance for the vast sums of money contractors are spending due to our environmental laws.

## **A. Environmental Costs**

The liabilities that arise out of various federal and state environmental statutes have expansive application. These laws impose requirements to comply with pollution prevention measures and to cleanup contaminated sites. Both types of requirements generate contractor costs.

### **1. Compliance Costs**

Government contractors are required, as are Mr. and Mrs. Smith, to comply with existing environmental statutory and regulatory requirements. Major federal environmental statutes include the: Comprehensive Environmental Response, Cleanup, and Liability Act,<sup>2</sup> Solid Waste Disposal Act,<sup>3</sup> Clean Air Act,<sup>4</sup> Federal Water Pollution Control Act,<sup>5</sup> Public Health Safety Act,<sup>6</sup> and Toxic Substances Control Act.<sup>7</sup> Contractors

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(g) Costs incurred in legal and other proceedings, and fines and penalties resulting from such proceedings are governed by [FAR] 31.205-47 and 31.205-15, respectively.

<sup>2</sup> 42 U.S.C. §§ 9601 to 9675 (hereinafter "CERCLA" or "Superfund").

<sup>3</sup> 42 U.S.C. §§ 6901 to 6992k (hereinafter "RCRA").

<sup>4</sup> 42 U.S.C. §§ 7401 to 7671q.

<sup>5</sup> 33 U.S.C. §§ 1251 to 1387 (hereinafter "Clean Water Act").

<sup>6</sup> 42 U.S.C. §§ 300f to 300j-26 (hereinafter "Safe Drinking Water Act").

<sup>7</sup> 15 U.S.C. §§ 2601 to 2692.

also must comply with what often are equally or more stringent state and local laws.<sup>8</sup> The Federal Acquisition Regulation ("FAR")<sup>9</sup> specifically acknowledges some of these responsibilities.<sup>10</sup> These compliance costs can be categorized as (1) non-discretionary costs of compliance with the drove of environmental statutes, and (2) discretionary costs of compliance.<sup>11</sup> For an example of the latter, self-audits are not specifically required. However, self-auditing programs are the most significant factor in the draft federal sentencing guidelines for offenses involving environmental crimes committed by organizations.<sup>12</sup> It would be improvident for a major corporation not to incur these costs.

In today's climate, environmental protection might well be too visible a concern to convince a board of contract appeals or a court that environmental compliance costs were outside the parties' contemplation when they entered into a contract.<sup>13</sup> Thus, contractors

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<sup>8</sup> Concerning cleanup, "Mini-CERCLA" statutes have been enacted in numerous states. *See, e.g.*, CAL. HEALTH & SAFETY CODE §§ 25300-25395 (West 1992 & Supp. 1995) and CAL. WATER CODE §§ 13000-13998 (West 1992 & Supp. 1995); N.J. REV. STAT. §§ 13:1K-6 to 13:1K-14 and N.J. REV. STAT. §§ 58:10-23.11 to 58:10-23.24; N.Y. ENVTL. CONSERV. LAW §§ 27-0900 to 27-0925 (McKinley 1984 and Supp. 1995) and N.Y. ENVTL. CONSERV. LAW §§ 27-1301 to 27-1321 (McKinley 1984 and Supp. 1995); and WASH. REV. CODE §§ 70.105D.010-70.105D.910 (West 1992 & Supp. 1995).

<sup>9</sup> C.F.R., Tit. 48.

<sup>10</sup> FAR 23.103(a) provides, "It is the Government's policy to improve environmental quality. Accordingly, executive agencies shall conduct their acquisition activities in a manner that will result in effective enforcement of the Clean Air Act and Clean Water Act." *See also*, FAR 52.223-2 and 52.223-3.

<sup>11</sup> *See generally*, Isaacson & McDonald, *Environmental Costs of Government Contractors: Cutting the Gordian Knot*, 62 FED. CONT. REP. (BNA) 628, 634 (1994) (hereinafter "McDonald & Isaacson II").

<sup>12</sup> *See*, Fiorelli & Rooney, *The Environmental Sentencing Guidelines for Business Organizations: Are There Murky Waters in Their Future?*, 22 B.C. ENVTL. AFF. L. REV. 481, 494-97 (1995).

<sup>13</sup> *E.g.*, *Atlas Corp. v. United States*, 895 F.2d 745 (Fed. Cir.), *cert. denied*, 498 U.S. 811, 111 S. Ct. 46, 112 L. Ed. 2d 22 (1990); *Overhead Elec. Co.*, ASBCA No. 25656, 85-2 BCA ¶ 18,026. *But see*, *Frank Lill & Son, Inc.*, ASBCA No. 35774, 88-3 BCA ¶ 20,880.

must build compliance costs into their contracts. Otherwise, they run the very real risk that they alone will have to shoulder the costs of environmental protection.<sup>14</sup> Recovery for environmental costs incurred in the performance of a fixed-price contract might be cognizable under the strained theories of differing site conditions<sup>15</sup> and constructive changes,<sup>16</sup> notwithstanding the significant limits of the Permits and Responsibilities

<sup>14</sup> See, Efron & Engel, *Recovery of Environmental Costs*, 92-3 COSTS, PRICING & ACCT. REP. 3, 12-13 (1992).

<sup>15</sup> FAR 52.236-2 (Differing Site Conditions clause). See, e.g., *Frank Lill & Sons, supra*, note 13 (quantity of asbestos a latent condition).

<sup>16</sup> FAR 52.243-1 (Changes, Fixed-Price clause). Under current decisional law, when nonfederal provisions are enforced contractors might not be able to recover the costs of compliance as changes in fixed priced federal contracts because the work is not ordered by the United States. See, *RPM Constr. Co.*, ASBCA No. 36965, 90-3 BCA ¶ 23,051 at 115,721. That case involved an appeal by an Army contractor that had contracted to install an underground fuel storage tank. The contract contained the FAR Permits and Responsibilities clause and two guaranty provisions that the tank would be leak-proof. As a result of a reported fuel leak, the state environmental agency cited the contractor and required as a remedial measure the contractor install three ground water monitoring wells. Because the contracting officer had not directed the work in question, and had expressly refused to allow the costs, the board held that the contractor's "remedy, if any, [lay] with a challenge to the state citations." In *Inman & Assocs., Inc.*, ASBCA Nos. 37869 *et al.*, 91-3 BCA ¶ 24,048, the board held the contractor was not entitled to costs incurred under a state's unwritten policy for cleaning up polychlorinated biphenyl ("PCB"), even though there had been no state adjudication of a violation. The case arose from a dispute involving a Navy contract after the contractor dropped a number of capacitors, some of which broke open and leaked PCB onto the ground. The contractor was prosecuted and convicted of violating the federal Environmental Protection Agency ("EPA") standard limiting surface traces of PCB to 25 parts per billion. However, because Texas had an unwritten policy with much more stringent limitations on PCB, the contractor, in a consent decree that did not include the contracting officer, agreed to incur cleanup costs beyond those required by the EPA penalty. As in *RPM Construction Co.*, the ASBCA concluded that the contractor's remedy, if any, was to appeal the state policy and not to pass on the costs through its government contract. The opposite result was reached in *Alonso & Carus Iron Works, Inc.*, ASBCA Nos. 38312 *et al.*, 90-3 BCA ¶ 23,148, *modified*, 91-1 BCA ¶ 23,650. The board held the Navy liable for cleanup costs due to its unreasonable refusal to allow the contractor to perform a test that would have prevented a fuel spill. The contract called for modification of a JP-5 fuel storage tank, and required the tank to be tested by filling it with fuel and examining it for leakage. Prior to the fuel test, the contractor requested permission to conduct a water test, but the contracting officer refused. The con-

(Continued next page . . .)

clause.<sup>17</sup> Of more relevance to this topic is the pricing of adjustments and modifications to fixed-price contracts and termination for convenience settlements,<sup>18</sup> and the allowability of compliance costs in cost-reimbursement contracts. More controversial than compliance costs, and the primary focus of this thesis, is cleanup costs.

## 2. Cleanup Costs

The controversy surrounding costs of removal<sup>19</sup> and remediation<sup>20</sup> of a release<sup>21</sup> or disposal<sup>22</sup> of hazardous substances<sup>23</sup> revolves around the position that government contractors should not be reimbursed for cleanup costs resulting from their fault, in contrast to the no-fault standard for cleanup liability.

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tractor conducted the test with fuel, and 91,000 gallons of JP-5 leaked out. Although the leak was the result of the contractor's negligent workmanship, it would have been discovered and corrected--and the spill averted--by a preliminary water test. The board found that the Navy had "breached its duty not to hinder performance," and thus assumed the risk of a spill. *Id.* at 116,203. *See also*, Manos, *Recovery of Environmental Costs: A Government Perspective*, 92-8 COSTS, PRICING & ACCT. REP. 3, 5 (1992).

<sup>17</sup> FAR 52.236-7 (requiring the contractor to comply with all Federal, State and local laws; contractor responsible for all damages to persons or property that occur as a result of the contractor's fault or negligence).

<sup>18</sup> *See*, FAR 31.102. FAR Part 31 cost principles are used in the pricing of fixed-price contracts, subcontracts, and modifications to contracts and subcontracts whenever (a) cost analysis is performed, or (b) a fixed-price contract clause requires the determination or negotiation of costs.

<sup>19</sup> *See*, CERCLA § 101(23), 42 U.S.C. § 9601(23) (emergency measures).

<sup>20</sup> *See*, CERCLA § 101(24), 42 U.S.C. § 9601(24) (permanent remedy).

<sup>21</sup> The term "release" means any spilling, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment of any hazardous substance. *See*, CERCLA § 101(22), 42 U.S.C. § 9601(22).

<sup>22</sup> "Disposal" is the discharge, deposit, injection, dumping, spilling, leaking, or placing of any solid waste or hazardous waste into or on any land or water so that such solid waste, hazardous waste or any constituent thereof might enter the environment or be emitted into the air or discharged into any waters, including ground water. *See*, RCRA § 1004(3) and CERCLA § 101(29), 42 U.S.C. §§ 6903(3) and 9601(29).

<sup>23</sup> *See*, CERCLA § 101(14), 42 U.S.C. § 9601(14) (reference to other environmental statutes to define the term).

### a. CERCLA

The Comprehensive Environmental Response, Cleanup, and Liability Act of 1980 is the primary statute that imposes liability for environmental cleanup. CERCLA liability is strict, retroactive, and joint and several.<sup>24</sup> Liability extends to a variety of potentially responsible parties ("PRPs"), including past and present owners and operators of contaminated facilities, and transporters and arrangers (generators) of hazardous substances.<sup>25</sup>

Under the 1986 Superfund Amendment and Reauthorization Act,<sup>26</sup> the federal agencies are included among parties responsible for environmental cleanup. A federal agency might be liable for cleaning up its own facilities.<sup>27</sup> If it contracts directly for such a cleanup,<sup>28</sup> it might be able to assert a contribution action against other parties also liable for the cleanup.<sup>29</sup> Federal agencies might also be liable for the cleanup of other than a federal facility. An agency can be named as a PRP<sup>30</sup> or sued by a PRP for contribution.<sup>31</sup>

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<sup>24</sup> See, CERCLA § 107(a), 42 U.S.C. § 9607(a). See, e.g., *United States v. Conservation Chem. Co.*, 589 F. Supp. 59, 62-63 (W.D. Mo. 1984); *United States v. Chem-Dyne Corp.*, 572 F. Supp. 802, 810 (S.D. Ohio 1983).

<sup>25</sup> See, CERCLA § 107(a), 42 U.S.C. § 9607(a).

<sup>26</sup> Pub. L. No. 99-499, 100 Stat. 1613 (hereinafter "SARA").

<sup>27</sup> See, CERCLA § 120, 42 U.S.C. § 9620.

<sup>28</sup> Cleanup contractors are referred to as "Response Action Contractors" or "RACs." Indemnity for RACs is available under the provisions of CERCLA § 119, 42 U.S.C. § 9619. See generally, Ness & Madsen, *Trends in Contractor Liability for Hazardous Waste Cleanups: The Current Legal Environment*, 22 PUB. CONT. L.J. 581 (1993). A RAC is potentially caught in the broad liability net of CERCLA if, for instance, the contractor efforts make matters worse.

<sup>29</sup> If an agency paid cleanup costs, it could seek reimbursement or possible contribution from another responsible party. To maintain a right of contribution, the cleanup action must have been consistent with the National Contingency Plan, *infra*, note 38. See, *United States v. Allied Signal Corp.*, 736 F. Supp. 1553 (N.D. Cal. 1990).

<sup>30</sup> See, CERCLA §§ 101(21) and 107, 42 U.S.C. §§ 9601(21) and 9607.

<sup>31</sup> See, CERCLA § 113(f)(1), 42 U.S.C. § 9613(f)(1).

Lastly, federal agencies might be required under the terms of their contracts to pay for the costs of cleanups indirectly by paying the cleanup costs incurred by their contractors. The draft environmental cost principle primarily concerns the latter.

#### **i. Liable Parties**

Liability is apportioned among PRPs. CERCLA defines a person as "an individual, firm, corporation, association, partnership, consortium, joint venture, commercial entity, United States Government, State, municipality, commission, political subdivision of a State, or any interstate body."<sup>32</sup> Persons liable for cleanup are:

- (a) present owners and operators of a facility,<sup>33</sup>
- (b) past owners and operators of a facility at the time of the disposal of a hazardous substance,<sup>34</sup>
- (c) persons who by contract, agreement, or otherwise, arranged for disposal or treatment of hazardous substances ("generators"),<sup>35</sup> and
- (d) those who accepted any hazardous substance for transport to a disposal or treatment facility selected by those persons ("transporters").<sup>36</sup>

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<sup>32</sup> CERCLA § 101(21), 42 U.S.C. § 9601(21).

<sup>33</sup> CERCLA § 107(a)(1), 42 U.S.C. § 9607(a)(1). *See also*, CERCLA § 101(9), 42 U.S.C. § 9601(9) ("Facility means any building, structure, installation, equipment, pipe, or pipeline . . . well, pit, pond, lagoon, impoundment, ditch, landfill, storage container . . . any site or area where hazardous substance has been deposited").

<sup>34</sup> CERCLA § 107(a)(2), 42 U.S.C. § 9607(a)(2); *see, FMC v. United States Dept. of Commerce*, 786 F. Supp. 471, 486 (E.D. Pa. 1992), *aff'd*, 29 F.3d 833 (3d Cir. 1993) (United States liable under CERCLA as an "operator," because the War Board supervised rayon manufacturing operations at the contractor's facility during World War II).

<sup>35</sup> CERCLA § 107(a)(3), 42 U.S.C. § 9607(a)(3).

<sup>36</sup> CERCLA § 107(a)(4), 42 U.S.C. § 9607(a)(4).

CERCLA provides for the right of contribution among PRPs, including the federal government.<sup>37</sup> The federal government, to the extent it incurred cleanup costs "consistent with" the National Contingency Plan might also bring a contribution action.<sup>38</sup>

## ii. Liability

CERCLA liability, in theory, is almost limitless. Each PRP is liable for the entire amount of damages, limited only by a single, full damage recovery. Joint and several liability removes the regulatory agency's burden of establishing the share of an injury for which each of multiple defendants is liable, and places the burden on the PRPs to determine their respective portions of liability.<sup>39</sup> Thus, a small contributor to a large environmental problem might be liable for costs far beyond its contribution. There are only three complete defenses to CERCLA liability. The defenses are:

- (1) an act of God,
- (2) an act of war, or
- (3) an act or omission of a third party exercising due care, other than an employee or agent of, or one whose act or omission occurs in connection with, a "contractual relationship" with a PRP.<sup>40</sup>

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<sup>37</sup> See, CERCLA § 113(f), 42 U.S.C. § 9613(f).

<sup>38</sup> The National Oil and Hazardous Substances Pollution Contingency Plan, also referred to as the National Contingency Plan ("NCP"), 40 C.F.R. § 300 *et seq.*, provides the organizational structure and procedures for preparing for and responding to discharges of oil and releases of hazardous substances, pollutants, and contaminants. Pursuant to CERCLA § 107(a)(4)(A), 42 U.S.C. § 9607(a)(4)(A), a PRP is liable for "all costs of removal or remedial action incurred by the United States Government or a State or an Indian tribe not inconsistent with the national contingency plan," and under § 9607(a)(4)(B) a PRP is liable for "any other necessary costs of response incurred by any other person consistent with the national contingency plan."

<sup>39</sup> See, e.g., *Azure v. City of Billings*, 182 Mont. 234, 596 P.2d 460 (Mont. 1979).

<sup>40</sup> CERCLA § 107(b), 42 U.S.C. § 9607(b). See generally, *United States v. Fairchild Indus., Inc.*, 766 F. Supp. 405, 410 (D. Md. 1991).

There is little likelihood those defenses would apply to any given government contractor cleanup.

Historically, CERCLA's strict liability provisions have been broadly construed,<sup>41</sup> since "CERCLA . . . is not a legislative scheme which places a high priority on fairness to generators of hazardous waste."<sup>42</sup> However, a trend might be appearing in the courts that provides some mitigation of CERCLA's harsh strict liability. For instance, in *Environmental Transportation Systems, Inc. v. ENSCO, Inc.*,<sup>43</sup> ENSCO was awarded a contract to dispose of out-dated transformers contaminated with PCB oil. The prime contractor hired a subcontractor to move the transformers from their original location to the prime contractor's facility. This subcontractor's truck overturned while carrying the transformers. The subcontractor subsequently sought contribution from the prime contractor and the original generator of the PCB waste to fund the cleanup effort. The 7th Circuit affirmed the district court's ruling that neither the prime contractor nor the original generator were subject to cleanup liability under CERCLA because the subcontractor was solely responsible for the PCB spill.

Several other cases also appear to indicate a trend limiting application of joint and several liability under CERCLA. The courts in those cases seem to recognize the harsh results that occur from literal application CERCLA strict liability. In *United States and*

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<sup>41</sup> See, *United States v. Monsanto Co.*, 858 F.2d 160, 167 (4th Cir. 1988), *cert. denied*, 490 U.S. 1106, 109 S. Ct. 3156, 104 L. Ed. 2d 1019 (1989); *see also*, *O'Neil v. Piccillo*, 682 F. Supp. 706 (D.R.I. 1988), *aff'd*, 883 F.2d 176 (1st Cir. 1989), *cert. denied sub nom. American Cyanamid Co. v. O'Neil*, 493 U.S. 1071, 110 S. Ct. 1115, 107 L. Ed. 2d 1022 (1990).

<sup>42</sup> *United States v. Rohm & Haas Co.*, 721 F. Supp. 666, 686 (D.N.J. 1989).

<sup>43</sup> 763 F. Supp. 384 (C.D. Ill. 1991), *aff'd*, 969 F.2d 503 (7th Cir. 1992).



*the State of New York v. Alcan Aluminum Corp.*<sup>44</sup> and *United States v. Alcan Aluminum Corp.*<sup>45</sup> federal and state enforcement authorities sought recovery of response costs from the disposer, Alcan. The courts in both cases allowed the disposer the opportunity to demonstrate the waste it emitted was not above the background level and, accordingly, should not be considered hazardous. *Bell Petroleum Services v. Sequa Corp.*<sup>46</sup> involved litigation between EPA and a PRP over the parties' respective liability for hazardous waste cleanup. EPA filed a cost-recovery action against various parties. Although the district court imposed joint and several liability on the parties to allow EPA's cost recovery, the Fifth Circuit reversed stating application of joint and several liability was not mandatory.<sup>47</sup> The Fifth Circuit decided<sup>48</sup> the "nature of the harm is the key factor in determining whether apportionment is appropriate" and a court must evaluate whether the harm is "distinct," "successive" or "divisible." If any of these factors is present, there is a "reasonable and just method for determining the amount of harm that was caused by each defendant (or in some cases, by an innocent cause or by the fault of the plaintiff)."<sup>49</sup>

<sup>44</sup> 990 F.2d 711 (2d Cir. 1993).

<sup>45</sup> 964 F.2d 252 (3d Cir. 1992) (remanded the issue of divisibility of harm stating, if contractor could establish harm to the environment was capable of reasonable apportionment, it could be held liable only for CERCLA response costs relating to that portion of harm to which it contributed). On remand, the court denied Alcan's motion for summary judgment holding that Alcan's emulsion as a whole was a CERCLA hazardous substance. It granted the government's motion for summary judgment because Alcan failed to present a genuine issue of fact concerning whether the harm was divisible. See, \_\_\_ F. Supp. \_\_\_, 1995 WL 41306 (M.D. Pa., June 28, 1995).

<sup>46</sup> 3 F.3d 889 (5th Cir. 1993).

<sup>47</sup> *Id.*, at 901.

<sup>48</sup> The court also summarized cases where federal courts have adopted three different methods for determining whether a defendant has proved harm at a site is divisible so as to avoid joint and several liability. *Id.*

<sup>49</sup> *Id.*, at 895-96, see also, Samelson, "Whose Liability is This Anyway?" *The Allowability of Environmental Cleanup Costs Potentially Attributable to Other Responsible Parties*, 24 PUB. CONT. L.J. 293, 307 (1995).

The legislative history of the act indicates concern that a joint and several liability standard could unfairly "impose financial responsibility for massive costs and damages . . . on persons who contributed only minimally (if at all) to a release or injury."<sup>50</sup> To determine apportionment, courts focus on the following criteria from the legislative history of the act (frequently referred to as the "Gore Factors"):<sup>51</sup>

- (a) the ability of the parties to demonstrate that their contribution to a discharge, release or disposal of a hazardous waste can be distinguished;
- (b) the amount of the hazardous waste involved;
- (c) the degree of toxicity of the hazardous waste involved;
- (d) the degree of involvement by the parties in the generation, transportation, treatment, storage, or disposal of the hazardous waste;
- (e) the degree of care exercised by the parties with respect to the hazardous waste concerned, taking into account the characteristics of such hazardous waste; and
- (f) the degree of cooperation by the parties with Federal, State or local officials to prevent any harm to the public health or the environment.<sup>52</sup>

### iii. Costs

The costs of cleanup include more than that spent for actual remediation. Additional costs include those for remedial investigations and evaluations (preliminary assessments, site investigations, and feasibility studies),<sup>53</sup> government administration, future monitoring and fines and penalties.<sup>54</sup> The average cost to clean up a single site has

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<sup>50</sup> 126 Cong. Rec. S15004 (1980) (Statement of Sen. Helms), *quoted in, Chem-Dyne Corp.*, *supra*, note 24.

<sup>51</sup> 126 Cong. Rec. H9461 (1980), *cited in, United States v. A & F Materials*, 578 F. Supp. 1249, 1256 (S.D. Ill. 1984); *see also, Bell Petroleum Service v. Sequa Corp.*, 3 F.3d 889, 901 n. 12 (5th Cir. 1993).

<sup>52</sup> *Id.*

<sup>53</sup> 40 C.F.R. §§ 300.420 and 300.430.

<sup>54</sup> *See, Efron & Engel, supra*, note 14, at 4.

been estimated at \$25 million.<sup>55</sup> As shall be seen, cleanups can become much more expensive.<sup>56</sup>

#### iv. Superfund

CERCLA initially established a \$1.6 billion Hazardous Substance Response Trust Fund, commonly referred to as the "Superfund," used to finance government response activities, to pay certain claims arising from the response activities of private parties, and to compensate federal or state governmental entities for damage caused to natural resources. Money for the Superfund was generated by a special excise tax on petroleum products and chemical feedstocks. Superfund revenues were to be collected over a five-year period ending in 1985, with \$1.38 billion collected from taxes and \$220 million from general federal revenues.<sup>57</sup> In addition to the original commitment of \$1.6 billion, Congress allocated not more than \$8.5 billion for the five-year period beginning October 17, 1986 and an additional \$5.1 billion for the three-year period commencing October 1, 1991.<sup>58</sup> Payments for cleanup are made from the Superfund when no solvent PRP is found to fund the cleanup activities.<sup>59</sup>

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<sup>55</sup> EPA estimated the average costs (in 1988 dollars) associated with a Remedial Investigation and Feasibility Study ("RI/FS") and design and implementation of a remedy at an National Priorities List ("NPL") site to be \$1.3 million for the RI/FS, \$1.5 million for remedial design, \$25 million for remedial action, and \$3.77 million for the present value of operation and management of the site remedy over 30 years. *See*, 57 Fed. Reg. 4824, 4829 (1992).

<sup>56</sup> *See*, pp. 92-109, *infra*.

<sup>57</sup> *See*, 42 U.S.C. § 9631(b) (repealed 1986).

<sup>58</sup> *See*, CERCLA § 111(a), 42 U.S.C. § 9611(a).

<sup>59</sup> *See generally*, Hansen, *CERCLA Cost Allocation and Nonparties' Responsibility: Who Bears the Orphan Shares?*, 11 UCLA J. ENVT'L. L. & POL'Y 37 (1992).

## b. RCRA

The Resource Conservation and Recovery Act<sup>60</sup> establishes a comprehensive management system and implements requirements for the generation, transportation, storage, treatment, and disposal of hazardous wastes.<sup>61</sup> RCRA broadly applies to generators and transporters of hazardous waste, as well as to owners and operators of hazardous waste treatment, storage and disposal facilities.<sup>62</sup> The statute was drafted to provide "cradle-to-grave" control of hazardous wastes at active facilities by imposing management requirements on the handling of such waste from a generating source to the site of its disposal.<sup>63</sup> Though RCRA focuses on current safe management of hazardous waste, it also has three provisions governing past activities.<sup>64</sup> Most important, RCRA

<sup>60</sup> See, RCRA, *supra*, note 3. The Solid Waste Disposal Act is better known by the name Resource Conservation and Recovery Act, which amended the basic statute.

<sup>61</sup> RCRA § 1004(5), 42 U.S.C. § 6903(5). The term "hazardous waste" includes any "solid waste, or combination of solid wastes, which because of its quantity, concentration, or physical, chemical, or infectious characteristics might (a) cause, or significantly contribute to an increase in mortality or an increase in serious irreversible, or incapacitating illness; or (b) pose a substantial present or potential hazard to human health or the environment when improperly treated, stored, transported, or disposed of, or otherwise managed.

<sup>62</sup> See, RCRA §§ 3002-3004, 42 U.S.C. §§ 6922-6924.

<sup>63</sup> See, generally, Case, *Resource Conservation and Recovery Act*, ENVIRONMENTAL LAW HANDBOOK 44 (15th ed. 1995).

<sup>64</sup> See, RCRA § 7003, 42 U.S.C. § 6973, "Imminent Hazard;" RCRA § 3004(u), 42 U.S.C. § 6924(u), Permit Conditions; and RCRA § 3013, 42 U.S.C. § 6934, "Monitoring, Analysis and Testing." RCRA § 7003 gives EPA authority "to bring suit . . . against any person (past or present generator, transporter, owner or operator of a treatment, storage, or disposal facility) who has contributed to the "handling, storage, treatment or disposal of any solid or hazardous waste which may present an imminent and substantial endangerment to health or the environment." See also, Amantea & Jones, *The Growth of Environmental Issues in Government Contracting*, 43 AMERICAN UNIV. L. REV. 1585, 1600-02 (1994). RCRA § 3004(u) requires that permits issued for active or closed waste management units, include provisions requiring corrective action for all releases of hazardous waste, regardless of the time at which waste was placed in the unit. RCRA § 3013 authorizes EPA to order the most recent owner or operator, who could reasonably be ex-

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section 7003 gives EPA broad authority to abate situations that "may present an imminent and substantial endangerment to health or the environment." This authority extends to any past or present handling, storage, treatment, transportation, or disposal of any solid or hazardous waste, and might be used notwithstanding any other provision of RCRA. A cleanup of a site not listed on the National Priorities List pursuant to the National Contingency Plan might nevertheless be directed by EPA or a state delegated enforcement authority under RCRA.<sup>65</sup> Since the 1984 amendments to RCRA,<sup>66</sup> all facilities issued a RCRA permit must take corrective action for contamination at or from the facility, including releases from past disposal.<sup>67</sup> Besides criminal penalties,<sup>68</sup> RCRA provides for civil judicial action, which might include an imposition of civil penalties of up to \$25,000 per day and injunctive relief for RCRA violations.<sup>69</sup>

### 3. Third Party Liability

FAR clause 52.228-7, "Insurance--Liability to Third Persons," required in most cost-reimbursement contracts, governs payments to third parties for personal injury or damage to property not owned, occupied or used by the contractor arising out of the

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pected to have actual knowledge of the presence of hazardous waste at a facility, to do the requisite monitoring and testing.

<sup>65</sup> See generally, *United States v. Colorado*, 990 F.2d 1565 (10th Cir. 1993), cert. denied, 114 S. Ct. 922, 127 L. Ed. 2d 216 (1994).

<sup>66</sup> Hazardous and Solid Waste Amendments of 1984, Pub. L. No. 98-616, 98 Stat. 3221 (hereinafter ("HSWA")).

<sup>67</sup> See, RCRA § 3004(u), 42 U.S.C. § 6924(u). The question of whether RCRA corrective actions will be viewed as compliance costs of acquiring and maintaining an operating permit, or a cleanup under the draft cost principle or current guidance is an open one.

<sup>68</sup> See, RCRA § 3008(d), 42 U.S.C. § 6928(d).

<sup>69</sup> See, RCRA § 3008(g), 42 U.S.C. § 6928(g).

performance of the contract, whether caused by the negligence of the contractor or not.<sup>70</sup>

Generally, these payments are reimbursed by the government notwithstanding availability of funds.<sup>71</sup> The language of the clause provides:

[T]he Contractor will be reimbursed--

(2) For certain liabilities (and expenses incidental to such liabilities) to third persons not compensated by insurance or otherwise without regard to and as an exception to the limitations of cost or the limitation of funds clause of this contract. These liabilities must arise out of the performance of this contract, whether or not caused by the negligence of the Contractor or of the Contractor's agents, servants, or employees, and must be represented by final judgments or settlements approved by the Government. These liabilities are for--

(i) Loss of or damage to property (other than property owned, occupied, or used by the Contractor, rented to the Contractor, or in the care, custody, or control of the Contractor), or

(ii) Death or bodily injury.<sup>72</sup>

Risk of loss, insurable or otherwise, in connection with a fixed-price contract is upon the contractor.<sup>73</sup>

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<sup>70</sup> See, FAR 28.311-2. The "Insurance--Liability to Third Persons" clause, purports to cover only "property damage and personal injury" suffered by third parties. See, Assumption by Government of Contractor Liability to Third Persons, Comp. Gen. Dec. B-201072 (1982). It is not clear whether cleanup costs incurred as a result of a successful CERCLA response cost action against the contractor fall within the meaning of "damages to property" of third parties. The term "property," as it applies to third parties, is not defined by the FAR. Courts have been split on the issue of what constitutes "property" in insurance litigation involving environmental cleanups. For example, one court has gone so far as to find that property damages occur when "the environment has been adversely affected by the pollution to the extent of requiring governmental action or expenditure." *Kipin Indus. Inc. v. American Universal Ins. Co.*, 41 Ohio App. 3d 228, 535 N.E. 2d 334 (1987). Another court, however, has characterized CERCLA response costs as economic losses instead of damage to tangible property. *Mraz v. Canadian Universal Ins. Co., Ltd.*, 804 F.2d 1325 (4th Cir. 1986).

<sup>71</sup> See, FAR 52.228-7(c)(2) & (d).

<sup>72</sup> FAR 52.228-7(c)(2)

<sup>73</sup> See, FAR 28.306.

Comprehensive General Liability policies are adhesion contracts written before the current environmental liability scheme was formed, but since rewritten attempting to exclude pollution damage. Interpretation of the provisions of those policies under circumstances leading to environmental liability is fraught with problems, resulting in much litigation without consistent precedent.<sup>74</sup> Today, specific pollution coverage is generally available only through Environmental Impairment Liability policies, which provide minimal coverage at great expense.<sup>75</sup> Indemnification in the absence of available insurance coverage might be available under a statutory program. Public Law No. 85-804 provides authority for the federal government to indemnify contractors.<sup>76</sup> This indemnification is for unusually hazardous or nuclear risks facilitating the national defense.<sup>77</sup> However, the inclusion of the necessary clause in the contract is in the hands of the procuring agency.<sup>78</sup>

#### 4. Enforcement

The Clean Air Act, Clean Water Act, and RCRA, for example, have a range of enforcement options to include informal or written notifications of violation ("NOVs"), and formal actions--administrative orders (orders requiring remedial action or refraining

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<sup>74</sup> See, Miller, *Defense Department Pursuit of Insurers for Superfund Cost Recovery*, 138 MIL. L. REV. 1 (1992); Ness & Madsen, *supra*, note 28, at 607; Steinbeck, *Liability of Defense Contractors for Hazardous Waste Cleanup Costs*, 125 MIL. L. REV. 55, 73 (1989).

<sup>75</sup> *Id.*

<sup>76</sup> See, National Defense Contracts Act, 72 Stat. 972 (1958), *codified at* 50 U.S.C. §§ 1431-35 (hereinafter "Pub. L. 85-804"); *see also*, United States GAO, *Defense Indemnification for Contractor Operations*, GAO/NSIAD-95-27 (1994) (GAO studied the military departments' use of Pub. L. 85-804 for indemnification of environmental liabilities; its conclusions were inconclusive).

<sup>77</sup> Pub. L. 85-804 § 1; 50 U.S.C. § 1431; *see also*, Executive Order No. 10789, 23 Fed. Reg. 8897 (1958), *reprinted in*, 50 U.S.C.A. § 1431, at 489-92.

<sup>78</sup> See, FAR Part 50; *see also*, Seymour, *Liability of Government Contractors for Environmental Damage*, 21 PUB. CONT. L.J. 491, 551 (1992).

from specified behavior), administrative penalties, court imposed civil and criminal penalties, and injunctive relief.<sup>79</sup> States have similar enforcement options.<sup>80</sup> Unique still among environmental laws is the cleanup compensation and liability scheme of CERCLA. CERCLA is at the core of the most difficult issues in government contract cost reimbursement.

## **B. Considerations**

This thesis examines the treatment of costs from the perspective of the "Iron Triangle" of the government, its contractors, and private concerns not doing business with the government yet incurring environmental costs (*e.g.*, Representative Synar's mythical Mr. and Mrs. Smith).

### **1. The Government Perspective**

The government is concerned that, if all environmental costs are allowed, government contractors might not be accountable for their actions. They could violate permit terms with impunity, with the result being environmental damage and otherwise avoidable costs paid by the government.

A contractor might also attempt to reduce the direct costs of its commercial work by failing to comply with environmental requirements and delaying cleanup efforts until it can charge a substantial portion of the costs to a government contract. A commercial concern would not have a similar incentive to delay incurring or reporting environmental

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<sup>79</sup> Enforcement provisions of the major media statutes include: Clean Air Act § 113, 42 U.S.C. § 7413; Clean Water Act § 309, 33 U.S.C. § 1319; RCRA § 3008, 42 U.S.C. § 6928; and CERCLA § 106, 42 U.S.C. § 9606.

<sup>80</sup> See, Kelly, *Liabilities and Enforcement*, ENVIRONMENTAL LAW HANDBOOK 495, 504 (15th ed. 1995).



costs. There might also be the suspicion that contractors might buy dirty property, pass along cleanup costs to the government, then sell the property to its financial advantage.

EPA has the authority to order a cleanup, or perform the cleanup itself and charge the PRPs.<sup>81</sup> The practicality of such a liability and administration scheme is that nearly all PRPs settle with EPA.<sup>82</sup> If all environmental costs are passed through to the government, a contractor has little incentive to achieve the lowest settlement for itself and the government, or aggressively pursue its insurers or other PRPs for contribution. Lastly, allowability decisions are made by contracting officers administering contracts with funds limitations. Program funds can quickly vanish since the costs of environmental cleanup are so high.<sup>83</sup>

## **2. The Government Contractor Perspective**

Many government contractors have but the one customer. Contractors also tend to have little realistic ability to limit the environmental liabilities that might result from contract performance by influencing the technical specifications or statements of work for products or services they supply to the government. Contractors currently performing

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<sup>81</sup> CERCLA §§ 104, 111, 42 U.S.C. §§ 9604, 9611

<sup>82</sup> The approach has been aptly characterized as a "carrot and stick." *In Re Acushnet River & New Bedford Harbor*, 712 F. Supp. 1019, 1027 (D. Mass. 1989); *United States v. Union Gas*, 743 F. Supp. 1144, 1152 (E.D. Pa. 1990).

<sup>83</sup> Fifteen of DOD's largest contractors estimate that their future environmental cleanup costs will total 2.1 billion. See, *Defense Department Reimbursement of Contractors' Environmental Cleanup Costs Before the Subcomm. on Legislation and National Security of the House Comm. on Government Operations*, 103d Cong., 1st Sess. 8 (1993) (statement of Donna M. Heivilin, Director, Defense Management and NASA Issues, National Security and International Affairs, General Accounting Office), reprinted in, United States GAO, *Unresolved Issues in Reimbursements to DOD Contractors*, GAO/T-NSIAD-93-12 (1993).

government contracts have no present control over past practices that have produced the enormous environmental liabilities--and some might never have had such control.<sup>84</sup>

Further, the Department of Justice ("DOJ") generally refuses to implement judicial enforcement actions on behalf of EPA against other federal agencies. The premise of the "unitary executive" theory is that all federal agencies are part of the same Executive Branch and one branch of the government cannot sue itself.<sup>85</sup> With the combination of the joint and several liability standard with the government's refusal to seek compensation from federal agencies in court, contractors can face huge liabilities with no easy method of sharing liability with the public contributors to the problem.<sup>86</sup>

Contractors also depend upon the allowability of costs to take advantage of progress payments as a financing method.<sup>87</sup> At the very least, some contractors have to footnote their financial statements consistent with Financial Accounting Standards to the effect that their environmental liabilities--the extent of which might be unknown and/or indeterminable--might be unallowable.<sup>88</sup> That, in turn, would adversely affect their

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<sup>84</sup> See, Efron & Engel, *supra*, note 14, at 3.

<sup>85</sup> See, *Solid Waste Disposal Act Before the Subcomm. on Transportation, Tourism, and Hazardous Materials of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. (1988) (statement of Roger J. Marzulla, Acting Asst. Atty. Gen., Land & Resources Div.).

<sup>86</sup> See, Efron & Engel, *supra*, note 14, at 4.

<sup>87</sup> See, McDonald & Isaacson, *Environmental Costs for Government Contractors: Gordian Knot Redux*, 57 FED. CONT. REP. (BNA) 847, 852 (1992) (hereinafter "McDonald & Isaacson I").

<sup>88</sup> *Id.*, at 851. Another thorny problem contractors will soon face is the treatment of impaired asset devaluation. Statement of Financial Accounting Standard No. 121 was recently issued by the Financial Accounting Standards Board and is effective for years beginning after Dec. 15, 1995. See, Steinberg, *FASB Issued Statement on Impairment*, 9 INSIGHTS 27 (1995). The standard is intended to lower the value of property diminished by changed circumstances, such as environmental liabilities. If the sum of expected future net cash flows, undiscounted and without interest charges (i.e., all the money the owner can

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creditworthiness and borrowing power. Finally, contractors have little prospect of having their environmental costs reimbursed fully. The unreimbursed costs would be allocated among its commercial and fixed-priced cost distribution bases. Costs not reimbursed would apply adequate incentive to ensure contractors minimize costs and seek other sources of reimbursement.

### **3. The Commercial Concern Perspective**

A commercial concern's dilemma is more easily understood. It simply passes its environmental costs on to its customers (to the extent the market will allow) or otherwise becomes less profitable, at least among certain product lines. The primary concern of a commercial business might be the tax deductibility of the costs.

#### **C. Thesis Stated**

This thesis examines the present state of the law concerning the allowability of environmental costs, what the draft environmental cost principle would change, and whether change is wise. Presently, all reasonable environmental costs are allowable if they are not prohibited by existing cost principles; *e.g.*, fines and penalties. Changes the draft environmental cost principle would institute, as shall be discussed, are unnecessary and

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ever reasonably expect to receive for that asset), is less than the carrying amount of the asset, the entity shall recognize an impairment loss in financial statements. The asset must be devalued to the lower of the carrying amount or fair value less sales costs. The devalued amount is used for, *inter alia*, depreciation. Once the value is stepped-down, it cannot be stepped-up--even if the environmental damage is remediated. *See*, Boyd & McDonald, *Heads I Win, Tails You Lose: The New Rules for Impaired Assets Under Government Contracts*, 62 FED. CONT. REP. (BNA) 61 (1994). There are no answers to the questions of allocability and allowability of these write-down expenses.

unwarranted. All reasonable environmental costs not disallowed by existing cost principles should be allowed.

This examination is particularly well timed. As shall become evident, the draft cost principle has led a roller-coaster life. It is on its last leg, at least in the form examined. However, the issues the draft environmental cost principle brought into controversy are enduring. The treatment of environmental costs will resurface. This study of the draft environmental cost principle will address issues that must be faced, in one form or another.

#### **D. Scope of Topic**

This thesis examines both the treatment of environmental costs allocable as direct costs and as indirect costs in cost-reimbursement contracting vehicles and in pricing modifications to fixed-price instruments.<sup>89</sup>

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<sup>89</sup> Contractor indemnification, *e.g.*, Pub. L. 85-804, is not analyzed here. *See*, FAR 52.250-1. The government contractor defense has been used to avoid tort liability, but will not be discussed further. *See*, *Boyle v. United Technologies Corp.*, 487 U.S. 500, 108 S. Ct. 2510, 101 L. Ed. 2d 442 (1988); *Berkovitz v. United States*, 486 U.S. 531, 108 S. Ct. 1954, 100 L. Ed. 2d 531 (1988); *see also*, *Crawford v. National Lead Co.*, 784 F. Supp. 439 (S.D. Ohio 1989). Lastly, recovery against the government for contribution as an arranger pursuant to CERCLA § 113(f)(1), 42 U.S.C. § 9613, will be referenced, but not considered in detail. Contractors may pursue these options if their cost reimbursement attempts fail.

## II. DRAFT COST PRINCIPLE HISTORY

### A. Round 1

The Air Force identified the need for consistent treatment of various environmental cleanup costs during the administration of a contract with Aerojet-General Corporation.<sup>90</sup> After examining contract clause proposals, the Air Force suggested to the Department of Defense ("DOD") that a cost principle be developed.<sup>91</sup> The Cost Principles Committee ("CPC") of the Defense Acquisition Regulation ("DAR") Council subsequently attempted drafting an environmental cost principle in 1987. Its draft reportedly made environmental cleanup costs allowable (in proportion to the government's share of the business at the affected site), provided that the contractor did not--when the pollution occurred--violate environmental laws or regulations and took steps to minimize environmental damage and cleanup costs.<sup>92</sup>

### B. Round 2

The DAR Council's Environmental Committee rewrote the CPC draft cost principle in February 1990 to limit sharply contractor recovery of cleanup costs. As reported,<sup>93</sup> the Environmental Committee's draft was silent about the allowability of costs associated with current environmental activities, and it would have allowed cleanup costs

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<sup>90</sup> See, discussion on pp. 92-99, *infra*.

<sup>91</sup> See, DAR Case 88-127, Environmental Cost Principle, Memorandum for the Director, DAR Council (May 10, 1990); see also, Efron & Engel, *supra*, note 14, at 4. Marc Efron and Devon Engel in this article divided the life of the draft environmental cost principle into rounds. This builds upon their work.

<sup>92</sup> *Spector Pulls Draft on Environmental Cleanup Costs*, 53 FED. CONT. REP. (BNA) 735 (1990).

<sup>93</sup> *Draft of Proposed Rules on Environmental Costs*, 53 FED. CONT. REP. (BNA) 686 (1990).

caused by past activities only at Government-Owned Contractor-Operated ("GOCO")<sup>94</sup> facilities--and then only if the contractor could demonstrate the following factors:

- (1) It was complying with then-existing law and regulations, or acting at the express direction of the contracting officer.
- (2) It had acted promptly to minimize the damage and costs associated with remedying the polluting activity.
- (3) It had obtained and maintained the kinds and minimum amounts of insurance required by the contract and had exhausted all legal and contributory sources (e.g., insurance, indemnification) to defray cleanup costs. If the contractor subsequently obtains funds as a result of legal action or other contributory source, it must refund or credit the government in accordance with established procedures under the FAR.<sup>95</sup>

The DAR Council approved this draft cost principle in April 1990 and, without obtaining final review from the Deputy Assistant Secretary of Defense for Procurement, forwarded it to the Civilian Agency Acquisition Council ("CAAC") for its comments before publishing it as a proposed rule.<sup>96</sup>

A storm of criticism ensued when the Environmental Committee's draft became known to the contractor community. Contractors were particularly upset by the failure of the cost principle to recognize the allowability of cleanup costs at Contractor-Owned and -Operated ("COCO")<sup>97</sup> facilities and by the cost principle's silence concerning the

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<sup>94</sup> For a discussion of GOCO liability, see, L. Gillory, *Environmental Liability Concerns Regarding Government-Owned Contractor-Operated Facilities: An Equitable Allocation of Risk* (1994) (unpublished thesis in Jacob Burns Law Library, George Washington University); Connor, *Government Owned-Contractor Operated Munitions Facilities: Are They Appropriate in the Age of Strict Environmental Compliance & Liability*, 13 MIL. L. REV. 1 (1991).

<sup>95</sup> *Draft Rule Would Limit Contractor's Recovery of Environmental Cleanup Costs*, 53 FED. CONT. REP. (BNA) 665 (1990).

<sup>96</sup> *Spector Pulls Draft on Environmental Cleanup Costs*, *supra*, note 92.

<sup>97</sup> A COCO facility is a non-government owned, privately operated facility that provided goods and/or services to a federal agency. For a discussion of COCO liability, see, (Continued next page . . .)

allowability of the costs for ongoing prevention efforts. The April 1990 draft cost principle neither addressed the government's contribution to past problems nor reflected an increased commitment to preserve the environment.<sup>98</sup>

Several weeks after the draft principle was sent to CAAC, the Deputy Assistant Secretary of Defense for Procurement withdrew it pending further DOD review. She later issued the following explanatory statement:

First, I do not believe it is fair to require contractors to absorb the costs of environmental cleanup if the performance of government contracts contributed to the pollution and if the contractor complied with environmental laws and regulations. Second, I do not believe disallowing such costs would be consistent with this Administration's position on environmental issues.

It is clear that President Bush and Congress consider environmental cleanup to be one of the most pressing public policy concerns of our time. Secretary Cheney echoed those same concerns when he recently promised to make DOD a model federal department for handling environmental issues. Against this backdrop, I believe the Government should pay its fair share of contractor environmental cleanup costs when the conditions set forth in the proposed cost principle are met.<sup>99</sup>

Significantly, in this explanation the Deputy Assistant Secretary confirmed that, without a specific cost principle, environmental cleanup costs "are currently allowable subject to the criteria in FAR 31.201-2."<sup>100</sup>

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C. Nilsson, *Defense Contractor Recovery of Cleanup Costs at Contractor Owned and Operated Facilities* (1993) (unpublished thesis in Jacob Burns Law Library, George Washington University).

<sup>98</sup> See, Efron & Engel, *supra*, note 14, at 5.

<sup>99</sup> Letter from E. Spector, Deputy Asst. Secy. of Defense for Procurement, to S. Evans, Asst. Administrator for Procurement, NASA (Jan. 18, 1991) (hereinafter "Spector Policy Letter"); see also, Efron & Engel, *supra*, note 14, at 5-6.

<sup>100</sup> See, Spector Policy Letter, *supra*, note 99; see also, Efron & Engel, *supra*, note 14, at 6.

### C. Round 3

The Deputy Assistant Secretary of Defense for Procurement referred the matter to the Office of Secretary of Defense and the Office of General Counsel.<sup>101</sup> This resulted in a new draft principle in October 1990. This version was similar to CPC's 1987 draft. It removed the restriction that allowed only GOCO cleanup costs, and provided that cleanup costs would generally be allowable provided they did not result from a contractor's violation of then-existing laws or regulations and the contractor took steps to minimize damage and costs. The DAR Council approved this version. It was then forwarded to CAAC.<sup>102</sup>

In December 1990, the proposal was again derailed. Before CAAC could approve it, the National Aeronautics and Space Administration's ("NASA's") representative to the FAR Council, citing his objections to both the substance of the draft cost principle and the process by which it was drafted, stated he would refuse to sign the draft cost principle when it came to the FAR Council for approval. He also stated the rule should be drafted more narrowly to "allow time for Federal agencies to assess the cost impact of environmental cleanup and explore with Congress means of financing these costs other than through program funds."<sup>103</sup>

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<sup>101</sup> *NASA Official Blocks DOD Rewrite of Environmental Costs Principle*, 54 FED. CONT. REP. (BNA) 878 (1990).

<sup>102</sup> *Id.*

<sup>103</sup> Letter from S. Evans, Asst. Administrator for Procurement, NASA, to E. Spector, Deputy Asst. Secy. of Defense for Procurement (Nov. 14, 1990); *see also*, Efron & Engel, *supra*, note 14, at 6. The Assistant Administrator's focus on protecting current program funds was misplaced because these funds were already jeopardized by the government's responsibility under the existing costs principles. As pointed out by the Deputy Assistant Secretary of Defense for Procurement:

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## D. Round 4

The draft rule was untouched for months until NASA appointed a new Assistant Administrator for Procurement. In June 1991, NASA's new Assistant Administrator reversed the position of her agency, agreeing with the DOD Assistant Secretary for Procurement it was unreasonable to place the entire burden of environmental cleanup on contractors. She stated her support for a cost principle similar to the third draft under which the government would share in the costs of environmental restoration.<sup>104</sup> In September 1991, the NASA Assistant Administrator asked the FAR Council to reopen the environmental cost principle case.<sup>105</sup> The DAR Council then again sent the draft to CAAC for its approval.<sup>106</sup>

Around this time, the Army and Navy departed from the Air Force and opposed the creation of an environmental cost principle. At the heart of their opposition, consistent with NASA's earlier position, was the fear of the financial impact on DOD--every dollar spent on the environment meant a dollar less for programs. Those services maintained the

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Your opposition to the cost principle seems to be based on concerns about increased costs. Since environmental costs are not explicitly addressed in the Federal Acquisition Regulation (FAR), they are currently allowable subject to the criteria in FAR § 31.201-2. Thus, the proposed cost principle would not make these costs allowable for the first time, but would instead ensure that contractor expenditures are consistently evaluated against an explicit set of rules.

Spector Policy Letter, *supra*, note 99.

<sup>104</sup> *Druyun Favors Allowability of Environmental Costs, Opposes DARC/CAAC Merger*, 56 FED. CONT. REP. (BNA) 5 (1991).

<sup>105</sup> *Druyun Lifts NASA Objections to Environmental Cost Principle*, 56 FED. CONT. REP. (BNA) 323 (1991).

<sup>106</sup> *See*, Efron & Engel, *supra*, note 14, at 6.

current general criteria in FAR 31.201-2 (*i.e.*, cost reasonableness, allocability, accounting standards and contract terms) would result in less cost to the government.<sup>107</sup>

## E. Round 5

The environmental cost principle that was expected did not emerge. It had been stalled in CAAC. However, in May 1992, a copy of a revised cost principle prepared by a joint DOD and civilian agency *ad hoc* group began circulating in the procurement community.<sup>108</sup> That draft was different from the first and third drafts, and--if accepted--would have restricted further the allowability of cleanup costs.<sup>109</sup>

Draft FAR 31.205-9(a) divides "environmental costs" into two categories: (1) costs incurred for the "primary purpose of preventing environmental damage," including disposing of wastes generated by current operations, and (2) costs incurred in "[c]orrecting environmental damage." However, costs resulting from a liability to a third party are specifically excluded from this draft cost principle.<sup>110</sup>

The draft FAR 31.205-9(b) would make costs in the first category, ongoing preventive costs, allowable except when they result from a violation of "law, regulation, or compliance agreement." However, the second category of costs, cleanup or restoration costs, would be unallowable, unless a contractor demonstrated each of the following:

- (1) The performance of a government contract contributed to the creation of the condition requiring correction.

<sup>107</sup> *Army, Navy Balk at Draft Environmental Cost Principle*, 56 FED. CONT. REP. (BNA) 863 (1991).

<sup>108</sup> *Draft Environmental Cost Principle Stalls in CAAC*, 57 FED. CONT. REP. (BNA) 669 (1992); *but see*, *CAAC Chairman Says Draft Rule is On Target*, 57 FED. CONT. REP. (BNA) 703 (1992).

<sup>109</sup> *See*, text of draft cost principle, note 1, *supra*.

<sup>110</sup> Third-party liability for environmental costs would, presumably, be considered under existing cost principles. *See*, discussion on pp. 70-71, *infra*.

(2) At the time of the creation of the condition requiring correction, the contractor was conducting its business in accordance with industry practices and environmental laws, regulations, and compliance agreements.

(3) It acted promptly to mitigate the damage and cost associated with correcting the condition.

(4) It had exhausted or was diligently pursuing all available sources of funds to defray the cost of cleanup.

(5) If the environmental condition requiring correction was caused by a previous owner or user of the affected property, that previous party met the first three tests outlined above and the contractor met tests three and four.<sup>111</sup>

The process to promulgate the draft cost principle as a proposed rule continued apace, with both the DAR Council and CAAC approving the draft without change. The FAR Secretariat submitted a proposed rule to the Office of Management and Budget to be issued for public comment, but a regulatory moratorium imposed by President Bush was then in effect.<sup>112</sup> This moratorium remained in effect for the remainder of the Bush Administration and continued after President Clinton took office.<sup>113</sup> Also, acquisition reform took precedence over the environmental costs issues.

## F. Round 6

The Defense Logistics Agency's Defense Contract Management Command ("DCMC") and the Defense Contract Audit Agency ("DCAA") launched a pilot study in

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<sup>111</sup> *Draft FAR Environmental Cost Principle*, 57 FED. CONT. REP. (BNA) 692 (1992).

<sup>112</sup> *See, Conyers Condemns Bush Administration "Bailouts" for Polluting Contractors*, FED. CONT. DAILY (BNA) (Oct., 27, 1992); *Environmental Cost Principle Cleared for Issuance as Proposed Rule*, 58 FED. CONT. REP. 184 (1992).

<sup>113</sup> In 1992, DCAA developed audit guidance for environmental costs, which was endorsed by Ms. Spector. *See*, pp. 77-85, *infra*. This audit guidance was viewed by the regulated community as instituting the policies of the draft cost principle during the moratorium without the benefit of policy-making procedures. *See*, McDonald & Isaacson II, *supra*, note 11, at 628-31.

March 1993.<sup>114</sup> That report, recently completed, prompted the Director of Defense Procurement<sup>115</sup> to instruct the CPC to reconsider what, if anything, should be done in light of the joint report.<sup>116</sup> What the next version of an environmental cost principle will look like is merely speculation at this time.

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<sup>114</sup> DCAA, DCMC Announce Pilot Program to Develop Guidance on Allowable Costs, 59 FED. CONT. REP. (BNA) 707 (1993). See also, discussion on p. 85, *infra*.

<sup>115</sup> Ms. Eleanor Spector, formerly the Deputy Assistant Secretary of Defense for Procurement.

<sup>116</sup> Spector Orders DAR Council to Reopen Environmental Cost Principle Case in Light of DCAA, DCMC Report, 63 FED. CONT. REP. (BNA) 339 (1995).

### **III. EXISTING COST PRINCIPLES**

There is no FAR provision that directly addresses the allowability of costs arising out of environmental protection and restoration.<sup>117</sup> Thus, under general principles of cost allowability, these costs should be allowed if they are reasonable, properly allocable to the contract or contracts at issue, and not specifically prohibited by the FAR or specific contract terms.

#### **A. General Allowability Principles**

FAR 31.201-2(a) lists the following factors to be considered in determining whether a cost is allowable:

- (1) Reasonableness.
- (2) Allocability.
- (3) Standards promulgated by the Cost Accounting Standards Board, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances.
- (4) Terms of the contract.
- (5) Any limitations set forth in FAR 31.2.

An allowable cost must satisfy all five factors. FAR 31.001 specifically defines an "unallowable cost" as, "Any cost which, under the provisions of any pertinent law, regulation or contract, cannot be included in prices, cost reimbursements, or settlements under a government contract to which it is allocable."

#### **B. Reasonableness**

Under the FAR as currently written, disputes over environmental costs would usually turn on whether those costs are "reasonable." The fact a contractor incurred a

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<sup>117</sup> The FAR only provides general clauses committing contractors to comply with clean air and clean water standards (FAR 52.223-3) and to abide by applicable federal, state and local laws in connection with hazardous materials (FAR 52.223-4). *See*, FAR Subpart 23.1.

cost to correct an environmental problem does not create a presumption the cost is reasonable.<sup>118</sup>

The FAR provides the following definition of a "reasonable" cost:

(a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive constraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer, or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.

(b) What is reasonable depends upon a variety of considerations and circumstances, including--

- (1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;
- (2) Generally accepted sound business practices, arm's length bargaining, and Federal and State laws and regulations;
- (3) The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and
- (4) Any significant deviations from the contractor's established practices.<sup>119</sup>

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<sup>118</sup> The last two sentences of FAR 31.201-3(a) were promulgated in Federal Acquisition Circular 84-26 (effective July 30, 1987). Congress in section 933 of the Defense Procurement Improvement Act of 1985, 10 U.S.C. § 2324(j), responded to the holding of *Bruce Constr. Corp. v. United States*, 163 Ct. Cl. 97, 324 F.2d 516 (1963) (incurred costs presumed reasonable). Although section 933 applied only to indirect costs of defense procurements, the FAR change was applied to defense and non-defense procurements, and direct as well as indirect costs. See, J. CIBINIC & R. NASH, *COST REIMBURSEMENT CONTRACTING* 728-29 (2d ed. 1993); Tomanelli, *Allowability of Environmental Cleanup Costs*, *THE ARMY LAWYER* 28 (Nov. 1992); *Reasonableness of Costs: Shifting the Burden of Proof*, *THE NASH & CIBINIC REP.* ¶ 61 (Aug. 1987).

<sup>119</sup> FAR 31.201-3.

There is no precedent regarding reasonableness of environmental costs. More significantly, there has never been a determination by a court or board of cost reasonableness in a context similar to the broad liability scheme of CERCLA. That statute's retroactive, strict, and joint and several liability makes it unique. The judicial trend of apportionment, previously discussed, is a complicating factor.<sup>120</sup> Perhaps more entangling is EPA's practice of settling liability. Section 122 of CERCLA authorizes EPA to enter into settlements with any responsible party to conduct a response action or resolve a party's liability to the United States under the act. Such a settlement must be entered as a consent decree, or embodied in an administrative order and reviewed by a court after public notice and comment.<sup>121</sup> The statute directs EPA to enter into settlements without regard to fault "as promptly as possible" with *de minimis* generator PRPs and *de minimis* landowners under specified circumstances.<sup>122</sup>

The courts have held that EPA has considerable discretion to allocate responsibility among PRPs by any "plausible" method.<sup>123</sup> The basic rule is that settlement must be based on some acceptable measure of comparative fault, apportioning liability according to "rational (if necessarily imprecise) estimates of how much harm each PRP had done."<sup>124</sup> Thus, a strict mathematical approach need not be used. Other special factors can be taken into account--such as each party's assumption of open-ended risk, the ability to obtain a cash-out settlement, and the desirability of reaching a quick settlement

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<sup>120</sup> See, pp. 9-12, *supra*.

<sup>121</sup> See, 42 U.S.C. § 9622.

<sup>122</sup> *Id.*

<sup>123</sup> See, *United States v. Cannons Engineering Corp.*, 899 F.2d 79, 88 (1st Cir. 1990); see also, Samelson, *supra*, note 49, at 308.

<sup>124</sup> See, *United States v. Cannons Engineering Corp.*, *supra*, note 123, at 87 (there is "no universally correct approach").

early in the process.<sup>125</sup> In reviewing the factors considered, courts give "great deference" to EPA's apportionment of liability in a settlement.<sup>126</sup>

Typically, the major PRPs' settlements with the environmental agencies do not conclusively determine each party's share of the ultimate costs to remediate the site. EPA settlements usually provide that every PRP remains jointly and severally liable for completing all work required by the consent decree. Each PRP's share of the costs of the cleanup effort is determined by negotiations among the PRPs and is governed by a separate agreement.<sup>127</sup>

The resolution of each PRP's share of the site allocation under CERCLA is further complicated by the effect of settlements on non-settling parties. In the 1986 SARA amendments to CERCLA, Congress enacted provisions to give PRPs financial incentive to settle their respective liability with the environmental regulators. Specifically, section 113(f)(2) provides that a responsible party that enters into a judicially or administratively approved settlement with the government will not be liable for contribution to other PRPs as to matters covered by the settlement.<sup>128</sup> As to non-settling parties, the statute provides that an approved settlement with a government agency does not discharge non-settlers

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<sup>125</sup> *Id.*, at 88.

<sup>126</sup> *See, United States v. Montrose Chemical Corp. of California*, 793 F. Supp. 237, 240 (C.D. Cal. 1992).

<sup>127</sup> *See, Samelson, supra*, note 49, at 310.

<sup>128</sup> *See, note 26, supra; see also, In Re Acushnet River & New Bedford Harbor, supra*, note 82. There are two exceptions where this protection will not apply: (a) private settlements, *see, Comerica Bank-Detroit v. Allen Indus.*, 769 F. Supp 1408, 1413 (E.D. Mich. 1991); and (b) settlors who are not liable under CERCLA can still be sued for contribution under state law, *see, United States v. Alexander*, 771 F. Supp. 830, 831 (S.D. Tex. 1991), *vacated*, 981 F.2d 250 (5th Cir. 1993). *See also, Samelson, supra*, note 49, at 310.



from liability--only that the extent of their liability is reduced by the amount of the settlement.<sup>129</sup>

Where a government contractor can find itself in this confusion is uncharted. This necessarily will require a case-by-case determination of reasonableness of incurred costs. The cases discussed below indicate that the full spectrum of cleanup cost incurrence scenarios must be determined for reasonableness.<sup>130</sup> There are no *per se* rules or easy answers.

## 1. Violation of Law or Permit

Despite this uncertainty, there appears to be consensus that costs resulting from violations of law are generally not reasonable.<sup>131</sup> However, the determination a law has been violated is not readily apparent in the no-fault context of CERCLA.

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<sup>129</sup> CERCLA § 113(f), 42 U.S.C. § 9613(f). *See also, United States v. Alcan Aluminum Corp.*, *supra*, note 44. In that case, ten years after the commencement of cleanup efforts, the United States and the State of New York brought a CERCLA § 107 action to recover response costs against 83 of the parties potentially responsible for the environmental problems at the site. The government entered into a consent decree with 82 of these PRPs, recovering 74% or \$9.1 million of the cleanup costs it had incurred. Alcan was the lone holdout. The government sued it for the \$3.2 million of unrecovered costs. Alcan then sought another (non-settling) PRP for contribution.

<sup>130</sup> *See*, pp. 92-109, *supra*.

<sup>131</sup> *See*, Steinbeck, *supra*, note 74; Seymour, *supra*, note 78; Nilsson, *supra*, note 97. *See also*, Draft Environmental Cost Principle, CAAC Case 90-101, DAR Case 91-56, Letter from American Bar Association, Section of Public Contract Law to Colonel Nancy L. Ladd, Director Defense Acquisition Regulations System (Aug. 24, 1992) (hereinafter "ABA Comments"). It was the Public Contract Law Section's position that a violation of the law should not be deemed to have occurred unless a final and unappealable judicial or administrative order has been entered by a court or administrative agency having jurisdiction over environmental matters.

### a. Adjudicated

Where there has been an actual adjudication of noncompliance with federal or state laws or regulations, the costs of correcting the noncompliance should generally be considered "unreasonable" under the criteria of FAR 31.201-3(b)(2), unless the government affirmatively required the contractor's violation. In some circumstances, however, even when a contracting officer concludes a contractor's conduct was not strictly in conformance with federal, state, or local environmental laws and regulations, the conduct might nevertheless have been reasonable. For example, particularly stringent environmental standards violated by a contractor might not have been technologically achievable,<sup>132</sup> or the government through its specifications or the actions of its contracting officer might have required or knowingly acquiesced in the contractor's hazardous waste treatment and disposal practices.<sup>133</sup>

According to the Armed Services Board of Contract Appeals:

[A c]ontractor's failure to prevail in the litigation is not dispositive of the issue of allowability. A determination of allowability must be made on a case-by-case basis and will be controlled by considerations of the reasonableness of the costs in nature and amount and whether their reimbursement is otherwise prohibited by some exclusionary cost principle. Factors to be considered include, but are not limited to, the facts and circumstances giving rise to the judgment or award and the punitive or compensatory nature of the ultimate award.<sup>134</sup>

<sup>132</sup> See generally, Aamodt, *The Mixed Waste Maze: A Guide for Working through Duplicate Regulations and Conflicting Jurisdictions*, 4 FEDERAL FACILITIES ENVTL. J. 139 (1993) (the control of mixed hazardous and radioactive wastes not presently achievable).

<sup>133</sup> Generally, the government cannot disallow costs retroactively if the contractor incurred them while performing an activity with the government's acquiescence. See, e.g., *Litton Systems, Inc. v. United States*, 196 Ct. Cl. 133, 449 F.2d 392 (1971).

<sup>134</sup> *Hirsch Tyler Co.*, ASBCA No. 20962, 76-2 BCA ¶ 12,075 at 57,985 (costs of non-malicious "technical violation" of Civil Rights Act allowed).

## **b. Non-adjudicated**

There will not always have been an adjudication of noncompliance, even if the contractor initially received a notice of noncompliance or violation from an environmental regulatory agency. Notices of violation are frequently settled by a consent decree in which the contractor agrees with the environmental regulatory agency (without notice to or consent of the contracting officer) to remedy the pollution without admitting liability. Generally, informal enforcement options are unilateral agency actions that are advisory in nature--such as a notice of noncompliance, NOV, or a warning letter--that cannot be challenged in court.<sup>135</sup> In these actions, EPA advises the manager of a facility what violation was found, what should be done to correct it, and by what date.<sup>136</sup> They are not final actions under the Administrative Procedures Act.<sup>137</sup> Appeals and court challenges are available only when the agency takes formal administrative, civil or criminal action.<sup>138</sup> The contracting officer must look behind the agency's regulatory actions and evaluate all the facts and circumstances to determine the reasonableness of the contractor's underlying conduct.

Whether a contractor settles or litigates a case to final disposition does not determine the reasonableness or allowability of cleanup costs, unless the contractor is fined or assessed penalties.<sup>139</sup> A contractor cannot settle a case and receive reimbursement

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<sup>135</sup> See, CERCLA § 113(h), 42 U.S.C. § 9613(h).

<sup>136</sup> *Id.*

<sup>137</sup> See, 5 U.S.C. §§ 701-706.

<sup>138</sup> See, RCRA § 3008, 42 U.S.C. § 6928, for formal enforcement options for RCRA violations, and CERCLA § 106, 42 U.S.C. § 9606 for CERCLA violations.

<sup>139</sup> See, FAR 31.205-47 for rules governing the recovery of legal costs upon settlement of a government proceeding; see, e.g., *Ravenna Arsenal, Inc.*, ASBCA No. 17802, 74-2 BCA ¶ 10,937.

for the costs if the underlying conduct is unreasonable.<sup>140</sup> It is not the terms of the settlement or method of assessment,<sup>141</sup> but the facts and circumstances of the case that are critical.<sup>142</sup> This is particularly important in CERCLA environmental cost reimbursement cases, since many cases are settled by a formal consent decree, approved by a federal district court.<sup>143</sup> Consent decrees are of limited value in determining the reasonableness of the contractor's actions that triggered the cleanup costs--liability not being dependent on fault.<sup>144</sup> As a general rule, neither EPA nor the state makes any effort to determine negligence or violation of law in finding CERCLA liability.<sup>145</sup> Their focus is on securing

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<sup>140</sup> See, *Joint Action in Community Service, Inc.*, LBCA No. 83-BCA-18, 88-3 BCA ¶ 20,949 at 105,866 (where the underlying facts indicated unreasonable conduct in the discharge of an employee under the Fair Labor Standards Act, the Board disallowed the settlement costs, stating: "if the contractor, who is thus in a position to require a formal adjudication of the validity of the charges against it, chooses instead to settle its way out of the dispute, the merits of the matter will never be determined, and the government would be in the anomalous position of acting as insurer protecting its contractors from any liability for violating the very standards that the selfsame government imposed upon them.").

<sup>141</sup> CERCLA gives EPA numerous mechanisms to recover costs and assess penalties. Using the Superfund, EPA can clean up the contamination and assess the contractor, seek injunctive relief to require the responsible parties to clean up the site, or enter into an agreement with responsible parties to perform any necessary response action. CERCLA § 104(a), 42 U.S.C. § 9604(a). The characterization of the remedy in terms of "restitution" or "damages" is not dispositive of the allowability of the costs. See, *Hirsch Tyler Co., supra*, note 134, at 57,986.

<sup>142</sup> See, Comptroller General Warren to Lt. Col. W. Gritz, United States Army, B-28322, 22 Comp. Gen. Dec. 349 at 9 (1942), one of the first decisions on this issue stated, "whether or not a [contractor] has failed to discharge its obligations . . . is a question of fact to be ascertained from the record in evidence presented to the Board . . ."

<sup>143</sup> See, CERCLA §§ 107, 122(d)(1)(a), 42 U.S.C. §§ 9607, 9622(d)(1)(a). For FY 1994, 35 consent decrees were referred to DOJ for cleanup response estimated at \$585 million. See, United States EPA, Enforcement and Compliance Assurance Accomplishments Report, FY 1994, CERCLA Enforcement, EPA 300-R-95-004, 4-8 at 4-9 (May 1995).

<sup>144</sup> See, CERCLA § 107, 42 U.S.C. § 9607

<sup>145</sup> See, United States GAO, *Observations on Consistency of Reimbursement to DOD Contractors*, GAO/NSIAD-93-77 19, 26 (1992).

an agreement to insure responsible parties cleanup the property, rather than on identifying any wrongdoing. In fact, in many cases, the consent decree states specifically the payments are not penalties or monetary sanctions.<sup>146</sup>

The contracting officer must look beyond the terms of any settlement to determine whether reimbursement is proper. A close review of the facts of the case might establish that the contamination occurred as a result of negligence or violations of other environmental laws.<sup>147</sup> If the underlying facts indicate unreasonable conduct, not withstanding the terms of the settlement agreement, the costs are not reimbursable.<sup>148</sup>

## **2. Fault**

Willful misconduct or failure to exercise due care might form the basis of an unreasonable cost. This includes due care of the contractor as an entity and its employees. Losses resulting from negligence of the employees that could be attributed to the contractor because of the contractor's practices, systems, or guidance, can preclude recovery.<sup>149</sup>

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<sup>146</sup> *Id.*, at 19. This practice is typified in the Aerojet case, *infra*, pp. 92-99. In 1979, the California Attorney General filed suit against Aerojet for violation of environmental laws, but subsequently agreed not to bring suit if the company entered into a consent decree to cleanup the contamination and pay a monetary claim to the state for environmental damage. The consent decree stated that none of Aerojet's payment under the decree were fines and penalties. To do otherwise might preclude the tax deductibility of CERCLA costs.

<sup>147</sup> DCAA audit guidance provides because there is no requirement the contractor be guilty of a violation to enforce contractor payment of cleanup costs, the "contractors should be requested to provide documents sufficient to allow a determination as to how the contamination occurred." *See*, Defense Contract Audit Agency, Department of Defense, DCAA Contract Audit Manual, DCAAM 7640.1, ¶ 7-1920.13 (1995) (hereinafter "DCAAM").

<sup>148</sup> *Id.*

<sup>149</sup> Generally, wrongful acts of employees will be a basis for cost disallowance only if  
(Continued next page . . .)

Since CERCLA imposes strict liability, contractors could be found liable for environmental restoration costs even when the earlier contamination was perfectly permissible under federal, state and local laws and regulations. Hence, the costs of remedying past environmental damage which occurred without any violation of laws, regulations or permits should be considered reasonable, and ordinary and necessary business expenses--unless a result of contractor fault.<sup>150</sup> In resolving the allowability of the costs of correcting past noncompliance, all factors are germane: (a) when the pollution occurred, (b) how it occurred, (c) what the applicable laws (federal, state, and local) and other requirements were when the pollution occurred, (d) what the standard industry practice was when the pollution occurred, and (e) whether the contractor was complying with the environmental requirements and industry practices when the pollution occurred.<sup>151</sup> These factors are currently relevant, albeit not expressly mentioned in the FAR definition of reasonableness. One should be mindful that proof of facts in this regard can be a tremendous obstacle. Evidence that can take the mystery out of conditions contributing to contamination sixty or seventy years ago is elusive.

### **C. Allocability**

To be reimbursable, environmental costs must be allocable to a government contract, as well as reasonable and allowable. The fundamentals of allocability are: (1)

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(. . . continued from last page)  
the conduct can be attributed to the contractor's management. *See, Morton-Thiokol, Inc.*, ASBCA No. 32629, 90-3 BCA ¶ 23,207; *Nolan Brothers, Inc.*, ENGBCA No. 2680, 67-1 BCA ¶ 6,095, *aff'd*, 194 Ct. Cl. 311, 437 F.2d 1371 (1971); *General Dynamics Corp.*, ASBCA No. 5166, 60-1 BCA ¶ 2,556.

<sup>150</sup> *See, DCAAM, supra*, note 147, ¶ 7-1920.13(e); *see also, Manos, supra*, note 16, at 8.

<sup>151</sup> *See, Efron & Engel, supra*, note 14, at 8.

the contractor's costs of doing business are charged to the government on the basis of relative benefit to and connection with the contract; and (2) if there is little or no benefit to the government, the costs are allocable only if "absolutely" necessary to the overall operation of the business.<sup>152</sup> The costs must be properly allocated to the government work in the period in which the costs were incurred.<sup>153</sup> According to the FAR:

A cost is allocable if it is assignable or chargeable to one or more cost objectives<sup>154</sup> on the basis of relative benefit received or other equitable relationship. Subject to the foregoing, a cost is allocable to a government contract if it--

- (a) is incurred specifically for the contract;
- (b) benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or
- (c) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.<sup>155</sup>

These are three separate categories of allocable costs and are stated in the disjunctive--so for environmental costs to be allocable they need only comply with one of the three requirements. However, all three cost categories are subject to the requirement of the first sentence of the provision that the cost be assignable "in accordance with the relative benefits received or other equitable relationship."<sup>156</sup>

If cleanup costs are the result of a release occurring during the performance of an existing government contract and there is a direct connection with only the one cost

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<sup>152</sup> See generally, CIBINIC & NASH, *supra*, note 118, at 658.

<sup>153</sup> See, Tomanelli, *supra*, note 118, at 30.

<sup>154</sup> A cost objective is usually a single government contract.

<sup>155</sup> FAR 31.201-4.

<sup>156</sup> See, *General Dynamics Corp., Elec. Boat Div.*, ASBCA No. 18503, 75-2 BCA ¶ 11,521.

objective, they would be direct costs of the contract.<sup>157</sup> However, typically costs of cleanup have no identifiable relationship to an existing government contract, and thus can only be allocated on the basis of benefit to more than one cost objective or, more likely, of necessity to the overall operation of the business.<sup>158</sup>

Whether costs would be recovered on the basis of their necessity to the overall operation of the business depends on the relative necessity of the costs.<sup>159</sup> The relationship between benefit and necessity was addressed by the Armed Services Board of Contract Appeals, stating:

Although we also are unable to enunciate any general rule or litmus paper test for allocability, it is clear and we hold that scope must be given to the element of "benefit" or other equitable consideration when determining the allowability of a necessary cost . . . Expenses which are absolutely necessary are for that reason alone beneficial to or bear an equitable relationship to government contracts. As the absolute necessity decreases, the contractor's burden to show some benefit or other equitable relationship with the government increases.<sup>160</sup>

There must be a showing by the contractor that either the costs incurred are absolutely necessary to the survival of the contractor's business or, if not absolutely necessary, the government benefited from the costs incurred.<sup>161</sup> Whether it is sufficient to show benefit that is general in scope or whether more direct benefit is required, depends on the analysis of the cost and the facts and circumstances under which it was incurred.<sup>162</sup>

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<sup>157</sup> See, FAR 31.202(a).

<sup>158</sup> See, FAR §§ 31.202 and 31.203; *see also*, Audit Guidance on the Allowability of Environmental Costs, Memorandum from M. Thibault, Assistant Director, Policy and Plans, for Regional Directors, DCAA Director, Field Detachment (Oct. 14, 1992) (hereinafter "1992 Guidance").

<sup>159</sup> See, CIBINIC & NASH, *supra*, note 118, at 671.

<sup>160</sup> *TRW Systems Group of TRW, Inc.*, ASBCA No. 11499, 68-2 BCA ¶ 7,117 at 32,967.

<sup>161</sup> See, CIBINIC & NASH, *supra*, note 118, at 671.

<sup>162</sup> See, *General Dynamics Corp., Elec. Boat Div.*, *supra*, note 156, at 54,973.



A showing of benefit, general in scope, is usually sufficient.<sup>163</sup> Although there are no published decisions on the allocability of environmental cleanup costs, it is apparent that cleanup costs, in many respects, fit squarely in the "absolute necessity" reasoning; *e.g.*, mandatory payments, responsibility as a corporate citizen, basic to the corporation's viability as a commercial enterprise, and so forth.<sup>164</sup> Recognizing the consequences that could befall a contractor that fails to remediate a "dirty" facility, remediation costs indeed seem "necessary."<sup>165</sup>

Allocation based on necessity is not, however, without limits. The Armed Services Board has cautioned:

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<sup>163</sup> See, *Lockheed Aircraft Corp. v. United States*, 179 Ct. Cl. 545, 375 F.2d 786, 793 (1967) (local taxes assessed solely on commercial inventory were allowed on the basis that the taxes were to be used to provide community services of benefit to all the business undertaken by the contractor; "it was the price of membership in that community . . . the benefits flowed to government contracts . . . in a general way . . . by the very fact that Lockheed was meeting its responsibilities as a corporate citizen, and specifically benefited by the services provided by the community"); *TRW Systems Group of TRW, Inc.*, *supra*, note 160 (patent costs were allocable to the government contract, finding the benefit to be "the protection afforded to the contractor which facilitated performance of the contracts and the . . . protection directly afforded the government against the payment of royalties [to others]"); *Machine Products Company, Inc.*, ASBCA No. 4577, 58-1 BCA ¶ 1,704 (payment of costs--attorneys fees, back wages, and arbiter expenses--incurred in a grievance procedure were found to benefit the government on the basis that "every element of the costs was payment in support of a system to maintain harmonious industrial relations"). In *General Dynamics Corp., Elec. Boat Div.*, *supra*, note 156, the board allowed allocation of commercial bid and proposal costs even though not an absolute necessity "in the sense that absent their incurrence the contractor would have had to close its doors." The board noted, "In a period when government business was on the decline, the costs were basic to appellant's viability as a commercial enterprise."

<sup>164</sup> *Id.*

<sup>165</sup> If a contractor fails to take remedial action after EPA has directed it to do so, it can be held liable for up to three times the costs EPA incurs "as a result of such failure to take proper action." CERCLA § 107(c)(3), 42 U.S.C. § 9607(c)(3). Moreover, with limited exceptions, a federal agency may not enter into, renew, or extend a contract with a firm proposing to use facilities listed by EPA as violating the Clean Air Act, *see*, § 306(a), 42 U.S.C. § 7606(a), or the Clean Water Act, *see*, § 508(a), 33 U.S.C. § 1368(a). *See also*, Executive Order No. 11,738, 38 Fed. Reg. 25,161 (1973); FAR 23.103(b).

We are not saying that any expenditure "necessary" to a business generally, and therefore beneficial to all output, should be allocated to government contracts. . . . We are saying that necessity and benefit may have a somewhat different meaning for certain kinds of costs both as a matter of logic and policy. This may be an extremely limited area. In the present situation, we attribute much significance to the fact that the challenged cost was a tax. It happens that this was local tax levied to cover community costs. Payment was not voluntary. These factors put it in a different category from charitable contributions, image-building or public relations expenses, and perhaps some other taxes. This distinction should illustrate that our approach does not lead to any litmus paper test for allocability.<sup>166</sup>

A contractor cannot allocate purely commercial costs to government contracts under the guise of costs necessary for the overall operation of the business where there is a direct relationship with another cost objective.<sup>167</sup> Whether environmental cleanup costs would be considered "absolutely necessary" to the overall operation of the business will require, like reasonableness, a case-by-case determination.

If the costs are not "absolutely necessary," there must be a showing of benefit.<sup>168</sup>

Costs incurred in the operation of an international division were not held allocable to the government contract without a showing the government's interests were enhanced by the international development.<sup>169</sup> Similarly, costs of retraining employees for a contractor's commercial operations after losing a follow-on contract were not allocable to the government contract. There the Armed Services Board held:

[M]orale enhancement [did] not supply the requisite benefit to charge the [government] contract with retraining costs. . . . Benefit accruing to the

<sup>166</sup> *Lockheed Aircraft Corp., supra*, note 163, as cited in, *General Dynamics Corp., Elec. Boat Div., supra*, note 156, at 54,972.

<sup>167</sup> *See, Dynalelectron Corp. v. United States*, 212 Ct. Cl. 118, 545 F.2d 736 (1979) (disallowing litigation costs incurred in a dispute related to a commercial transaction); *Chrysler Corp.*, NASA BCA No. 1075-10, 77-1 BCA ¶ 12,482 (costs incurred at an off-site facility for commercial production were not allocable because they were a direct cost of the commercial undertaking).

<sup>168</sup> *See, The Match Institution*, HUDBCA No. 87-1850-C2, 91-2 BCA ¶ 23,994.

<sup>169</sup> *See, Id.*

government contract [need not] be susceptible to precise mathematical measurement . . . but whether one takes a broad or narrow view of the benefit concept, there must be some reasonable relationship of the incurred costs to the contract to be charged.<sup>170</sup>

Additional considerations exist. The costs a contractor incurs in one accounting period may not be allocated to final cost objectives in different accounting periods.<sup>171</sup>

Consequently, a contractor cannot allocate its environmental cleanup costs to a government contract in the current accounting period if it incurred those costs in a prior accounting period. If a contractor does incur cleanup costs in an accounting period in which it is performing a government contract, it might contend the government should allocate those costs to the contract. This conclusion, however, does not necessarily follow. To be allocable, the cost the contractor incurred must have beneficial or causal relationship to contracts in the same accounting period.<sup>172</sup> A government attorney might suspect deception when a contractor reports a significant increase in its environmental cleanup costs while it is performing more government contracts than it normally would. This ostensible increase might indicate the contractor has delayed its remediation efforts until it could get the government to pay for them.<sup>173</sup>

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<sup>170</sup> *Metropolitan Life Insurance Co.*, ASBCA No. 27,161, 85-2 BCA ¶ 17,973.

<sup>171</sup> The G&A expense pool of a business unit for a cost accounting period shall be allocated to final costs objectives of that costs accounting period. 48 C.F.R. §410.40(b)(1) (1992) (hereinafter "CAS 410.40(b)(1)").

<sup>172</sup> CAS 410-50(a), *supra*, note 171; 48 C.F.R. § 9904.418-50(b) (1992) (hereinafter "CAS 418-50(b)").

<sup>173</sup> The Defense Contract Audit Agency Manual suggests that auditors should question "out-of-period" costs. *See*, DCAAM, *supra*, note 147, ¶ 6-608.3(b)(1) ("The object . . . is to disclose those indirect costs which have been assigned to a current period when the cost was incurred for the purpose of benefiting a future or past period"); *see also*, Tomanelli, *supra*, note 118.

Although a cost must be allocable to be "allowable," allowability is generally recognized to be the province of FAR Part 31, the cost principles. Since the draft environmental cost principle is a creature of FAR Part 31, further treatment of allocability, such as equitable allocation of indirect costs, is not appropriate here.<sup>174</sup>

#### **D. Accounting Standards**

After determining allocability, the Cost Accounting Standards ("CAS")<sup>175</sup> and Generally Accepted Accounting Principles ("GAAP")<sup>176</sup> deal with whether those costs should be expensed as current period costs or amortized--rather than with their allowability.<sup>177</sup> As with the discussion of allocability, CAS and GAAP shall only be examined to the extent necessary to discuss the adequacy of the existing cost principles.<sup>178</sup>

#### **E. Contract Terms**

Discussion of contract terms is limited to advance agreements. Advance agreements are one way the parties to a contract seek to avoid disputes and litigation concerning the allowability of costs. The parties negotiate and agree about the treatment

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<sup>174</sup> *I.e.*, base period, cost pool, and distribution base. *See*, CIBINIC & NASH, *supra*, note 118, at 676-702. However, allocability is revisited in the discussion of the DCAA guidance for treatment of environmental costs, pp. 79-82, *infra*.

<sup>175</sup> 48 C.F.R. Part 9904. Cost Accounting Standards are promulgated differently than FAR Part 31 cost principles. Cost Accounting Standards are under the jurisdiction of the Cost Accounting Standards Board. *See*, 41 U.S.C. § 422.

<sup>176</sup> *See generally*, Lemmer & Davis, *GAAP & Government Contract Cost Accounting: A Survey of Theory & Practice*, COSTS, PRICING & ACCT. REP. 3 (Nov. 1992).

<sup>177</sup> *See, e.g.*, Financial Accounting Standards Board Emerging Issues Task Force ("EITF") Issue 90-8 (providing that costs incurred to treat environmental contamination should generally be expensed; except for the following, which should be capitalized: (1) costs to extend the life, increase the capacity, or improve the safety or efficiency of the contractor's property, (2) costs to mitigate or prevent environmental contamination that has yet to occur and that otherwise might result from future operations or activities, or (3) costs incurred in preparing property currently held for sale).

<sup>178</sup> *See*, pp. 79-82, *infra*.

of certain costs before their incurrence. In an attempt to encourage this practice, the FAR includes a provision authorizing advance agreements and specifying procedures to be followed in negotiating such agreements. FAR 31.109 states:

The extent of allowability of the costs covered in this part applies broadly to many accounting systems in varying contract situations. Thus, the reasonableness and allocability of certain costs may be difficult to determine, particularly for firms or their divisions that may not be under effective competitive restraints. To avoid possible subsequent disallowance or dispute based on unreasonableness or nonallocability, contracting officers and contractors should seek advance agreement on the treatment of special or unusual costs. However, an advance agreement is not an absolute requirement and the absence of an advance agreement on any cost will not, in itself, affect the reasonableness or allocability of that cost. . . . The contracting officer is not authorized by this 31.109 to agree to a treatment of costs inconsistent with this part.

There is nothing--other than perhaps the bureaucratic reluctance to deviate from standard contract terms--that prevents the terms of the draft environmental cost principle, for instance, from being included in an advance agreement, in whole or as modified by the parties.<sup>179</sup>

## **F. FAR Subpart 31.2**

FAR Part 31.2 would be the permanent home of the draft environmental cost principle if promulgated. It should first be stated these cost principles serve, primarily, to

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<sup>179</sup> See, DCAAM, *supra*, note 147, ¶ 7-1920.15. The Director of Defense Procurement, has not discouraged the practice of incorporating the draft environmental cost principle into advance agreements, although representatives of the National Security Industrial Association have urged her to do so. See, *Spector Says No "Loophole" Exists for Improper Recovery of Environmental Cleanup Costs*, 34 GOV'T CONTRACTOR (Fed. Pubs.) ¶ 567 (1992).

disallow otherwise reasonable and allocable costs.<sup>180</sup> The burden to prove cost principle applicability, unlike the burden of reasonableness, is upon the government.<sup>181</sup>

## **1. Lack of, Inconsistent Cost Principles**

### **a. Two or More Cost Principles**

FAR 31.204(c) contains the following rule for determining allowability when a specific type of cost is covered by two or more cost principles containing different allowability rules:

When more than one subsection in 31.205 is relevant to a contractor cost, the cost shall be apportioned among the applicable subsections, and the determination of allowability of each portion shall be based on the guidance contained in the applicable subsection. When a cost, to which more than one subsection in 31.205 is relevant, cannot be apportioned, the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with, or best captures the essential nature of, the cost at issue.

### **b. Costs Not Specified**

The fact a cost is not specifically mentioned in the cost principles is not determinative of allowability. FAR 31.204(c) states:

Section 31.205 does not cover every element of cost. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be based on the principles and standards in this subpart and the treatment of similar or related selected items.

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<sup>180</sup> See, CIBINIC & NASH, *supra*, note 118, at 747-48.

<sup>181</sup> See, *Lockheed-Georgia Co.*, ASBCA No. 27660, 90-3 BCA ¶ 22,957 at 115,276.

## **2. Specific Cost Principles**

### **a. Fines and Penalties (FAR 31.205-15)**

Under FAR 31.205-15, "[c]osts of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, and local, or foreign laws and regulations" are not allowable.<sup>182</sup> Indeed, the strict liability aspect of CERCLA, in which liability exists without regard to fault, makes it probable that most Superfund settlements can be achieved without a finding a law has been violated, making disallowance of CERCLA cleanup costs on the grounds they are fines or penalties "questionable."<sup>183</sup>

However, even fines and penalties are allowable under FAR 31.205-15 if they were "incurred as a result of compliance with specific terms and conditions of the contract or written instructions of the contracting officer."<sup>184</sup> At least one court has indicated a contractor might recover from the government fines and penalties assessed under an environmental statute if the contractor could prove it was acting in compliance with the contract terms at the time the environmental violations occurred (although the resulting settlement agreement stipulated the contractor's reimbursement was not based on the "Fines, Penalties, and Mischarging Costs" cost principle).<sup>185</sup> Thus, even if a contractor pays penalties or fines for violating an environmental law, it might review closely its

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<sup>182</sup> FAR 31.205-15(a).

<sup>183</sup> See, Letter from J. Hinchman, General Counsel, GAO, to Rep. J. Conyers, Jr. (D-Mich), B-246822.2, at 4 (Feb. 3, 1992) (hereinafter "Hinchman Letter").

<sup>184</sup> FAR 31.205-15(a).

<sup>185</sup> See, *United States v. General Dynamics Corp.*, 755 F. Supp. 720 (N.D. Tex. 1991) (summary judgment denied on counterclaim alleging entitlement to indemnification from Air Force for Clean Air Act violation); see also, Efron & Engel, *supra*, note 14, at 10.

government contracts to determine if the contracts' terms and condition were also violated. If not, the costs of the penalties and fines might be allowable.<sup>186</sup>

Fines assessed for "merely technical violations"<sup>187</sup> and penalties assessed notwithstanding reasonable efforts to comply<sup>188</sup> might or might not be reimbursable. Just because the assessment is called a penalty, it is not automatically disallowed. The boards of contract appeals look behind the decision resulting in the assessment, and reexamine the contractor's conduct and the extent of fault.<sup>189</sup>

Even though the incurrence of cleanup costs to remedy contamination resulting from past activities is, in a sense, a legal obligation and generally not the result of fines or penalties, CERCLA actions are often intertwined with the imposition of fines and penalties for violations of the other environmental statutes. Unless these fines and penalties were incurred as a result of compliance with specific terms and conditions of the contract or written instruction from the contracting officer, they are unallowable.<sup>190</sup> In addition, the imposition of fines and penalties resulting from CERCLA violations or violations of other

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<sup>186</sup> See, Efron & Engel, *supra*, note 14, at 10.

<sup>187</sup> See, *Hirsch Tyler Co.*, *supra*, note 134 (costs of non-malicious "technical violation" of Civil Rights Act allowed); *but see*, *Columbia University*, ASBCA No. 3862, 57-1 BCA ¶ 1,340 (reimbursement disallowed on fines imposed for failure to get proper approvals from the Immigration and Naturalization Service before dismissing alien crew members).

<sup>188</sup> See, *Metropolitan Denver Constr. Opportunity Policy Committee*, LBCA No. 73-BCA-118, 74-2 BCA ¶ 10,749 (reimbursement of the cost of a penalty for late payment of taxes disallowed).

<sup>189</sup> See, *McDonnell Douglas Corp.*, NASA BCA No. 865-28, 68-1 BCA ¶ 7,021 (reimbursement allowed for costs in workman's compensation case after a state court finding of misconduct); *see also*, *Ravenna Arsenal, Inc.*, *supra*, note 139 (amount paid to settle suits alleging violation of Civil Rights Act and Equal Opportunity clause allowable since violation not established. *But see*, *Joint Action in Community Service*, *supra*, note 140, at 98,603 (similar costs disallowed since they did not contribute to contract performance; violation established).

<sup>190</sup> See, FAR 31.205-15.



environmental statutes can be strong evidence of unreasonable conduct that would make the cleanup costs, and also associated legal and other professional costs unallowable.<sup>191</sup>

Presumably, the costs of Supplemental Environmental Projects ("SEPs") will not be allowable. Nominally, SEPs are projects voluntarily undertaken by members of the regulated community in conjunction with case settlements to provide some level of environmental benefit, usually unrelated to the nature of the violations committed. In exchange for SEP performance, the facility is granted penalty relief equaling some fraction of the total value of the stipulated penalty.<sup>192</sup> SEPs are generally costlier than the penalties. A SEP would likely be characterized as a penalty and disallowed. Such a characterization, however, would deter SEPs, to the detriment of environmental concerns.

#### **b. Legal and Other Proceedings Costs (FAR 31.205-47)**

Costs incurred in connection with the defense or prosecution of claims or appeals against the federal government are unallowable.<sup>193</sup> If the proceeding is brought by a third party, FAR 31.205-33 "Professional and Consultant Services Costs,"<sup>194</sup> applies to retained counsel and contracted legal services, and the general principles of allowability govern the reimbursement of costs for in-house legal services.

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<sup>191</sup> See, FAR 31.205-47 and -33.

<sup>192</sup> See, Enforcement and Compliance Assurance Accomplishments Report, FY 1994, *supra*, note 143, at 3-9 to 3-12.

<sup>193</sup> See, FAR 31.205-47(f)(1). Claims, as used in this subpart, means a written demand or written assertion by one of the contracting parties seeking, as a matter of right, the payment of money in a sum certain, the adjustment or interpretation of contract terms, or other relief arising under or relating to the contract. See also, FAR 33.201.

<sup>194</sup> Discussed *infra*, pp. 56-58.

FAR 31.205-47 makes unallowable the costs incurred in civil or administrative proceedings when they result in monetary penalties or another disposition was such it could have led to a monetary penalty.<sup>195</sup> Specifically, FAR 31.205-47(b) provides in pertinent part:

Costs incurred in connection with any proceeding brought by a Federal, state, local or foreign government for violation of, or a failure to comply with, law or regulation by the contractor (including its agents or employees) are unallowable if the result is--

- (1) In a criminal proceeding, a conviction;
- (2) In a civil or administrative proceeding, either a finding of contractor liability where the proceeding involves an allegation of fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct.

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- (4) Disposition of the matter by consent or compromise if the proceeding could have led to any of the outcomes listed in subparagraph (b)(1)[ or (b)(2).]"

The overall approach of this cost principle is to render unallowable, the costs of certain proceedings.<sup>196</sup> Costs covered are (1) administrative and clerical expenses; (2) legal services costs, whether performed by in-house or retained counsel, (3) costs of accountants, consultants, or other retained experts, and (4) the costs of employees, officers, and directors.<sup>197</sup> The categories of costs contained in FAR 31.205-47 remain illustrative and not exhaustive. Indeed, the definition of "costs" itself recognizes costs "similar" to the listed costs "incurred before, during, and after commencement of a judicial

<sup>195</sup> See, FAR 31.205-47. The "Proceedings" cost principle, as amended, became effective on January 22, 1991.

<sup>196</sup> See, Schechter & Kelly, *The Proceedings Cost Principle*, COSTS, PRICING & ACCT. REP. 15, 19 (March 1991).

<sup>197</sup> See, FAR 31.205-47(a).

or administrative proceeding which [bear] a direct relationship to the proceedings" come within the cost principle's ambit.<sup>198</sup> Included are:

All costs which would not have been incurred but for the proceeding. This includes costs incurred before, during and after the proceeding. The concept of "before the proceeding" should be interpreted to cover the following: (1) when a contractor anticipates and begins to prepare for a proceeding before it has been officially notified that a governmental unit has initiated a proceeding and (2) when the contractor is conducting its own investigation or inquiry preparatory to initiating a proceeding.<sup>199</sup>

The type of governmental action that constitutes a proceeding is not precisely defined in the FAR. A working definition in the DCAA Contract Audit Agency Manual states:

A proceeding includes any investigation, administrative process, inquiry, hearing, or trial conducted by a local, state, Federal, or foreign governmental unit and appeals from such proceeding. Note that for the purposes of this cost principle, the term proceeding includes, but is not limited to, those related to actions which in nature are criminal, noncriminal, fraud, non-fraud, contract-related, or non-contract-related. The definition is very broad.<sup>200</sup>

The cleanup of a contaminated site under CERCLA is an administrative process that frequently involves a combination of investigations,<sup>201</sup> inquiries,<sup>202</sup> hearings,<sup>203</sup> and

<sup>198</sup> See, *Id.*

<sup>199</sup> DCAAM, *supra*, note 147, ¶ 7-1918.2(a).

<sup>200</sup> *Id.*, at ¶ 7-1918.2(b).

<sup>201</sup> CERCLA § 104(b), 42 U.S.C. § 9604(b), authorizes EPA to "undertake such investigations, monitoring, surveys, testing, and other information gathering as deemed necessary or appropriate to identify the existence and extent of the release or threat thereof." CERCLA § 104(e)(3), 42 U.S.C. § 9604(e)(3), allows EPA to enter property to inspect and obtain samples of suspected hazardous substances, either after consent of the property owner or, if consent is refused, EPA may issue an order, enforced by judicial action. See also, CERCLA § 109, 42 U.S.C. § 9609.

<sup>202</sup> See, Environmental Protection Agency, Superfund Program: Notice Letter, Negotiations and Information Exchange, 53 Fed. Reg. 5298, 5306-07 (1988); CERCLA § 104(e)(2), 42 U.S.C. § 9604(e)(2), authorizes EPA to require any person who has or might have information relevant to contamination and cleanup to furnish information and

(Continued next page . . .)

trials.<sup>204</sup> However, it is still an open question what, if any, part of the CERCLA cleanup process would be considered a "proceeding" and what legal costs would be allowed.

Again, the primary goal of CERCLA is to get the contaminated site cleaned up promptly and paid for by those parties responsible for the contamination, not to ferret out violators and assess penalties. Nonetheless, EPA has the power to take administrative and judicial actions to penalize recalcitrants if, during the CERCLA cleanup process, responsible parties are not cooperating, not in compliance with the law, or in violation of settlement agreement terms. For example, EPA under CERCLA section 104(e) is authorized to require information and documents regarding a potential CERCLA site to determine the appropriate response action or to enforce CERCLA.<sup>205</sup> Failure to comply fully with such a request could result in civil penalties of up to \$25,000 per day.<sup>206</sup> Similarly, EPA can issue Unilateral Administrative Orders ("UAOs") "as may be necessary to protect public health and welfare and the environment" when EPA "determines that there may be an imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release of a hazardous substance from a facility."<sup>207</sup> UAOs include findings of fact, conclusions of law, and administrative

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documents. In addition, that person must grant EPA access to inspect and copy all documents or records relating to such matters.

<sup>203</sup> See, CERCLA § 122(h)(2), 42 U.S.C. § 9622(h)(2), "Settlements"; 40 C.F.R. § 304.11(a), "Use of Arbitration," CERCLA § 107(l)(1), (4), 42 U.S.C. § 9607(l)(1), (4) (EPA has authority to impose liens, enforced by an action "in rem" in the appropriate federal district court).

<sup>204</sup> See, CERCLA § 113, 42 U.S.C. § 9613.

<sup>205</sup> See, CERCLA § 104(e)(1), 42 U.S.C. § 9604(e)(1).

<sup>206</sup> See, CERCLA § 104(e)(5)(b), 42 U.S.C. § 9604(e)(5)(b).

<sup>207</sup> See, CERCLA § 106(a), 42 U.S.C. § 9606(a).

determinations.<sup>208</sup> The PRPs are afforded an opportunity to participate in a non-evidentiary conference with EPA, with the scope limited to implementation issues of the required response actions and the extent to which the respondent intends to comply with the order.<sup>209</sup> Failure to comply with the order could result in a penalty of \$25,000 per day for the duration of the noncompliance.<sup>210</sup> If EPA takes the required response actions, a cost recovery lawsuit in federal district court can result in punitive damages of up to three times the response costs incurred by the Superfund, in addition to the cleanup costs.<sup>211</sup> These administrative actions are "proceedings." However, it is not until judicial or administrative enforcement actions are taken to enforce the UAO or recover EPA's response costs that the "allowability" of proceeding costs becomes an issue.

Without case law or further regulatory guidance on the allowability of legal costs in CERCLA cases, each proceeding in the CERCLA process must be evaluated to determine the allowability. To the extent the "proceeding" does not involve an issue that could result in monetary penalties,<sup>212</sup> the CERCLA action would not be the type of proceeding that would preclude reimbursement for legal fees, if otherwise reasonable. FAR 31.205-47(e) states that proceedings costs "not made unallowable" by FAR 31.205-47(b) might be allowable if reasonable and not otherwise recovered by the

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<sup>208</sup> M. FOGELMAN, *Section 106(a) Unilateral Administrative Orders*, HAZARDOUS WASTE CLEANUP LIABILITY AND LITIGATION § 4.6 (1st ed. 1992).

<sup>209</sup> *Id.*, at 83.

<sup>210</sup> *See*, CERCLA § 106(b), 42 U.S.C. § 9606(b).

<sup>211</sup> *See*, CERCLA § 107(c)(3), 42 U.S.C. § 9607(c)(3).

<sup>212</sup> A penalty does not include a payment to make a unit of government whole for damages or the interest accrued on the damages. A penalty is in the nature of a punitive award. DCAAM, *supra*, note 147, ¶ 7-1918.2(c).

contractor. The costs might be allowable if the matter is dropped by the government after investigation or the contractor is successful in defending itself in a proceeding.<sup>213</sup>

Even if a contractor succeeds, the cost principle limits the allowability of proceedings costs incurred to "the percentage determined to be appropriate considering the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions against the United States as a party, and such other factors as may be appropriate."<sup>214</sup> The cost principle precludes the percentage of recovery from exceeding 80 percent, unless--as part of a consent or compromise agreement--the government and contractor agree to a higher level of reimbursement after explicitly recognizing the 80-percent rule.<sup>215</sup>

### **c. Professional and Consultant Services (FAR 31.205-33)**

Costs of professional and consultant services, including legal services, are those rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor.<sup>216</sup> These costs are generally allowable under FAR 31.205-33 when the costs are well-documented, necessary, and reasonable in nature and scope, considering the contractor's capability in the particular area, and are not made unallowable by any other cost principle.<sup>217</sup>

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<sup>213</sup> CIBINIC & NASH, *supra*, note 118, at 825.

<sup>214</sup> FAR 31.205-47(e).

<sup>215</sup> *See, Id.*

<sup>216</sup> *See*, FAR 31.205(a).

<sup>217</sup> *See*, FAR 31.205-33(a) & (b). Environmental cleanup projects, and perhaps audits, generally require significant inputs by consultants, engineers, and other experts. *See also*, Efron & Engel, *supra*, note 14, at 11; Weitzel. *The Professional & Consultant Service Cost Principle*, COSTS, PRICING & ACCT. REP. 13 (Oct. 1989).

Reimbursement is generally not contingent on the outcome.<sup>218</sup> According to the Armed Services Board of Contract Appeals, legal fees and the costs of satisfying an award or judgment are separate and distinct and "the distinction between these types of costs must be observed in determining their allowability."<sup>219</sup> The board noted:

[A]n ordinarily prudent person in the conduct of competitive business is often obliged to defend lawsuits brought by third parties some of which are frivolous and others of which have merit. In either event, the restraints or requirements imposed by generally accepted sound business practices dictate that, except under the most extraordinary circumstances, a prudent businessman would incur legal expenses to defend a litigation and that such expenses are of the type generally recognized as ordinary and necessary for the conduct of a competitive business.<sup>220</sup>

The board held legal expenses incurred in defending a civil litigation brought by a third party, regardless of the outcome are "prima facie" reasonable and allowable, unless shown to have been incurred unreasonably or reimbursement is expressly prohibited by an exclusionary cost principle.<sup>221</sup> In determining the allowability of a professional or consultant services, the contracting officer is required to consider the following factors: (1) the nature and scope of the service rendered in relation to contract performance, (2) the necessity of the service, (3) the past pattern of this service's cost, (4) the portion of the contractor's business dedicated to government contracts, (5) whether the portion of the contractor's government contract business is likely to affect the incurrence of the service,

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<sup>218</sup> *But see, Joint Action in Community Service, supra*, note 140.

<sup>219</sup> *See, Hirsch Tyler Co., supra*, note 134, at 57,986.

<sup>220</sup> *Id.*, at 57,985-86.

<sup>221</sup> *Id.*; *see also, Appeal of Hayes Int'l Corp.*, ASBCA No. 18447, 75-1 BCA ¶ 11,076 at 52,721-27 (even though the Equal Employment Opportunity Commission found evidence of discrimination, legal fees were reimbursed because there was no finding of willful or malicious conduct). *But see, Joint Action in Community Service, Inc., supra*, note 140 (legal costs were unreasonably incurred when the contractor found in violation of a federal statute).

(6) whether the contractor could perform the service more economically in-house, (7) the qualifications of the individual or firm offering the service, and (8) the adequacy of the contractual agreement for the service.<sup>222</sup>

The case law and the FAR allow reimbursement for legal costs, notwithstanding the allowability of the costs of satisfying an award or judgment. Exactly how this will be applied to environmental litigation is unclear. Contribution actions among PRPs are to be expected. The courts and boards have not decided the allowability of legal fees issue under these circumstances. However, if these expenses are reasonable and allocable to a government contract, there is no basis for denying reimbursement.<sup>223</sup> With regard to PRPs, DCAA advises allowable environmental costs should only include the contractor's share of the cleanup costs based on the actual percentage of the contamination attributable to the contractor, and any costs, including legal fees, the contractor cannot collect pursuant to their contribution and subrogation rights, are unallowable, because they are in their essential nature "bad debts."<sup>224</sup>

#### **d. Bad Debts (FAR 31.205-3)**

The entire text of this cost principle reads, simply, "[b]ad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection costs, and legal costs are unallowable."<sup>225</sup> As previously discussed, when a contractor pays for more than its share

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<sup>222</sup> See, FAR 31.205-33(d).

<sup>223</sup> See generally, FAR § 52.228-7 "Insurance--Third Party Liability" and the section on allocability, *supra*, pp. 40-46.

<sup>224</sup> See, DCAAM, *supra*, note 147, ¶ 7-1920.10(b).

<sup>225</sup> FAR 31.205-3.



of the site cleanup, the contractor receives a right of contribution against the other PRPs who did not make an appropriate contribution to the cleanup effort.<sup>226</sup> DCAA has determined, in keeping with FAR 31.204(c),<sup>227</sup> if a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are--in their "essential nature"--bad debts.<sup>228</sup>

Uncollected contribution is not technically a bad debt. A bad debt arises and is properly charged against income after (1) a firm obligation to pay has been established and the receivable has been recognized as income, (2) the third party subsequently becomes unable (or refuses) to pay the receivable, and (3) there is a small likelihood of recovery through collection or legal action.<sup>229</sup> The characterization of uncollected contribution as an unallowable bad debt has been criticized as improper and impractical, and allowability should instead be based in actual incurred costs.<sup>230</sup>

Perhaps in response to concerns such as these, DCAA recently amended its guidance to auditors to provide this exception:

The guidance . . . does not apply in situations when all of the following three conditions are met: (1) a contractor is legally required to pay another PRP's share of the clean-up costs, (2) that PRP is out of business, and (3) there is no successor company having assumed the PRP's liabilities. When these three conditions are met, the cleanup costs which are attributable to the other PRP's contamination should not be disallowed as bad debt type expenses since there is no one against whom the contractor can take recovery action.<sup>231</sup>

<sup>226</sup> See, *supra*, p. 7.

<sup>227</sup> The determination of allowability of costs not specified are to be based on the principles and standards in FAR Part 31 and the treatment of similar or related selected items. See, p. 48, *supra*.

<sup>228</sup> DCAAM, *supra*, note 147, ¶ 7-1920.10(b).

<sup>229</sup> See, Samelson, *supra*, note 49, at 303.

<sup>230</sup> *Id.*, at 312-14.

<sup>231</sup> DCAAM, *supra*, note 147, ¶ 7-1920.12(c).

The DCAA position on environmental bad debts of other PRPs is a tenuous and might not withstand challenge. For example, a decision not to pursue a *de minimis* PRP when risks of recovery and costs of litigation are high might be more akin to a prudent business decision than a bad debt.

**e. Credits (FAR 31.205-5)**

Some criticism of the application of the bad debts cost principle includes recognition of the broad application of the "Credits" cost principle. FAR 31.205-5 requires a contractor to credit the government a *pro rata* portion of any "income, rebate, allowance or other credit" relating to any allowable cost. The credits cost principle implements what has been described as the government's equitable right to receive its fair share of funds recovered by a contractor from another source, when recovery relates to costs previously allowed in pricing a government contract.<sup>232</sup> Thus, as matters now stand, if a contractor recovers insurance proceeds for cleanup costs under its comprehensive liability policy, the government would be entitled to a credit from the contractor to the extent the overall cleanup costs were allowable.<sup>233</sup>

The Armed Services Board of Contract Appeals characterized the scope of the credits cost principle as "especially sweeping."<sup>234</sup> To sustain the government's right to a credit, the boards of contract appeals have required a close match be demonstrated between the costs recognized under a government contract and the income or monetary

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<sup>232</sup> See, Schechter, *The Credits Cost Principle*, COSTS, PRICING & ACCT. REP. 11, 15 (May 1989).

<sup>233</sup> See, Efron & Engel, *supra*, note 14, at 9.

<sup>234</sup> *NI Industries, Inc.*, ASBCA No. 34943, 92-1 BCA ¶ 24,631 at 122,913, *recons. denied*, 92-2 BCA ¶ 24,980.

rebate subsequently received by a contractor.<sup>235</sup> So long as this requirement is met, FAR 31.201-5 applies in a number of different circumstances.<sup>236</sup>

Concerning implementation, the regulation permits the contractor either to apply the credit as a cost reduction or submit a direct cash refund to the government. DCAA prefers that the credit be made directly to the contract on which the refund or rebate is received.<sup>237</sup> In a typical situation, a contractor's cleanup costs would usually be charged as an indirect cost to all the company's commercial and government contracts. A credit for such costs then might be made through a reduction of the applicable indirect cost pool or by another equitable method.<sup>238</sup> In most circumstances, both the contractor and the procuring agency would prefer the reduction to be made as a credit against other allowable costs (rather than as a direct payment to the United States Treasury), because this would reduce the costs of the particular government program being performed.<sup>239</sup>

In the case of environmental costs, it is clear the credits cost principle would apply to a recovery received from another PRP for remediation costs previously allowed. It would not be difficult to demonstrate the match between the recovery from the PRP and the cleanup costs allowed in pricing a contract. Thus, in agreeing to recognize the full amount of a contractor's otherwise allowable costs incurred in complying with CERCLA,

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<sup>235</sup> See, *Kleen-Rite Corp.*, GSBCA Nos. 5893 *et al.*, 83-2 BCA ¶ 16,582; *Celesco Industries*, ASBCA No. 20569, 77-1 BCA ¶ 12,445.

<sup>236</sup> These include state and local tax refunds, accrued but unpaid royalty expenses, adjustments to workers' compensation rates, and credits or reductions in employer contributions to pension plans, death benefits plans and other group insurance plans. DCAAM, *supra*, note 147, ¶ 6-608.2(d)(5)(b).

<sup>237</sup> *Id.*, at ¶ 6-608.2(d)(5)(a).

<sup>238</sup> *Id.*

<sup>239</sup> See, Samelson, *supra*, note 49, at 316.

the government would not be giving up its right to recoup its fair share of a subsequent recovery from another PRP when recovery is obtained.<sup>240</sup>

#### **f. Insurance (FAR 31.205-19)**

In cost-reimbursement contracts, the contractor is ordinarily required to obtain insurance for workers' compensation, general liability, and other matters.<sup>241</sup> When the government requires a contractor to obtain insurance, the premiums are allowable costs.<sup>242</sup> For example, costs of insurance for the risk of loss or damage to government property are allowable only to the extent that a contractor is liable for the loss or damage and such insurance does not cover loss or damage that results from willful misconduct or lack of good faith on the part of the contractor's directors or officers.<sup>243</sup> However, this insurance would not cover catastrophic environmental losses.<sup>244</sup> Environmental Impairment Liability insurance is needed.<sup>245</sup> Since contracts rarely require the contractor to obtain environmental impairment insurance, the costs of the insurance would not be an allowable cost; and, environmental impairment insurance is largely unobtainable. Even where it is available, the insurer typically offers limited coverage with a sizable deductible.<sup>246</sup> Therefore, it is unlikely insurance could be obtained--even if the government approved the

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<sup>240</sup> *Id.*

<sup>241</sup> *See*, FAR 28.311-2.

<sup>242</sup> *See*, FAR 31.205-19(a)(1).

<sup>243</sup> FAR 31.205-19(a)(2)(iv); *see also*, Seymour, *supra*, note 78, at 532.

<sup>244</sup> Environmental damages are, or might be, insurable losses under the comprehensive general liability provisions of older policies. *See*, Miller, *supra*, note 74, at 15-16. The treatment of these insurable losses are problematic. Note the impact of insurance in the GAO case studies discussed on pp. 92-109, *infra*.

<sup>245</sup> *See*, p. 17, *supra*.

<sup>246</sup> *See*, Seymour, *supra*, note 78, at 532.

purchase of such insurance--that would provide adequate protection from environmental risks.<sup>247</sup>

The FAR provides that self-insurance charges for risks of catastrophic losses are not allowable.<sup>248</sup> If performance under the contract creates a risk of catastrophic loss, the government "may, to the extent authorized by law, agree to indemnify the contractor or recognize an appropriate share of premiums for purchased insurance, or both."<sup>249</sup>

### **g. Contingencies (FAR 31.205-7)**

FAR 31.205-7 disallows costs for funds reserved by the contractor to cover contingencies. Contingencies include possible future events or conditions arising from presently known or unknown causes, the outcome of which is presently indeterminable. Accordingly, the contractor probably could not establish a reserve fund to deal with potential liability for hazardous waste cleanups or other environmental harms because the government refuses to be charged for costs that might not be incurred during contract performance.<sup>250</sup>

However, the same clause provides that future costs reflecting contingencies are recoverable when they arise from presently known and existing conditions, the effects of which are foreseeable within reasonable limits of accuracy.<sup>251</sup> Applying this test, a

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<sup>247</sup> See, FAR 28.307, 31.205-19. However, the FAR also provides that certain uninsured losses and lump-sum settlements are allowable costs. See, FAR 31.205-19(a)(3)(i). Cleanup costs excluded from the contractor's comprehensive general liability policy might be viewed as allowable uninsured losses. See also, Seymour, *supra*, note 78, at 532.

<sup>248</sup> See, FAR 31.205-19(e).

<sup>249</sup> See, FAR 28.308(e); Seymour, *supra*, note 78, at 532. See also, indemnification provisions of Pub. L. 85-804 for unusually hazardous or nuclear risks facilitating the national defense, implemented by FAR Part 50.

<sup>250</sup> See, Seymour, *supra*, note 78, at 531.

<sup>251</sup> See, FAR 31.205-7(c)(1).

contractor might be able to negotiate an advance agreement<sup>252</sup> to cover reasonable estimates of future environmental costs. Such an estimate presumably would need to be based on a site assessment or other careful study of site conditions.<sup>253</sup> For example, in a competitive negotiation, if a contractor recognizes certain contract work necessarily would involve distinct costs to protect the environment, it could identify those expenses in its cost proposal and negotiate them with the government during the competition. Even if these costs cannot be precisely computed, they might be included in the final negotiated price under FAR 31.205-7 as a "contingency."<sup>254</sup>

#### **h. Maintenance and Repair Costs (FAR 31.205-24)**

Although not yet tested in a reported decision, FAR 31.205-24 supports allowability of on-site environmental restoration costs necessary to keep a facility in

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<sup>252</sup> Discussed at pp. 46-47, *supra*.

<sup>253</sup> See, Seymour, *supra*, note 78, at 531.

<sup>254</sup> *Id.*, at 521. Although the government may assert the uncertainty of costs associated with environmental contamination make a contractor's environmental contingency costs unallowable, an argument exists to support a claim for such contingency costs. On June 8, 1993, the Securities and Exchange Commission ("SEC") provided specific guidance regarding reporting requirements for environmental contingencies. SEC's recent interpretive release, Staff Accounting Bulletin No. 92, directs that companies should estimate future contingent environmental liabilities, and provides that:

[A corporate] registrant should consider available evidence including the registrant's prior experience in remediation of contaminated site, other companies' clean-up experience, and data released by the Environmental Protection Agency or other organizations. . . . Even in the situations in which the registrant has not determined the specific strategy for remediation, estimates of the costs associated with the various alternative remediation strategies . . . may be available or reasonably estimable.

See, Wise, Maniatis, Ammann & Koch, *Estimating Contingent Environmental Liabilities: An Approach to Achieve SEC Compliance*, 24 ENVTL. REP. 1577 (1993).

operable condition.<sup>255</sup> FAR 31.205-24 allows normal maintenance and repair "[c]osts necessary for the upkeep of property . . . that neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition."<sup>256</sup> This cost principle provides for the recovery of expenditures for plant and equipment, including rehabilitation--although this latter category of expenses is to be capitalized and subject to depreciation.<sup>257</sup> Lastly, extraordinary maintenance and repair costs are allowable, provided those costs are allocated to the applicable periods.<sup>258</sup>

Environmental cleanup can be analogized to any other extraordinary facility cleanup effort included within the category of maintenance operations.<sup>259</sup> A contractor could argue some environmental response costs are allowable because they consist of property upkeep costs. Such costs--including remediation of soil and groundwater contamination resulting from contract work--might be characterized as necessary to the preservation or renovation of the facilities.<sup>260</sup> However, they might be characterized as adding to the property's future value. In that instance, this cost principle would not support arguments for allowability.

While the maintenance and repair cost principle might provide an additional justification for claiming reimbursement for normal and expected rehabilitation or maintenance costs, the provision probably would not permit a contractor to recover environmental cleanup costs arising from its negligence, or a violation of federal or state

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<sup>255</sup> See, Efron & Engel, *supra*, note 14, at 10-11.

<sup>256</sup> FAR 31.205-24(a)(1).

<sup>257</sup> See, FAR 31.205-24(b). This assumes that land and water remediation might be depreciable.

<sup>258</sup> See, FAR 31.205-24(a)(2).

<sup>259</sup> See, Tomanelli, *supra*, note 118, at 31.

<sup>260</sup> See, Seymour, *supra*, note 78, at 532.

laws. Rather, the clause appears to be directed toward costs incurred by the contractor in conducting maintenance and repair of facilities and property in its possession due to common deterioration or reasonably expected wear and tear.<sup>261</sup>

### **i. Plant Reconversion Costs (FAR 31.205-31)**

The plant reconversion cost principle allows the costs of removing government property at contractor facilities and the restoration or rehabilitation costs caused by such removal.<sup>262</sup> The cost principle provides:

Plant reconversion costs are those incurred in restoring or rehabilitating the contractor's facilities to approximately the same condition existing at the time immediately before the start of the Government contract, fair wear and tear excepted. Reconversion costs are unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent agreed upon before costs are incurred.

Because of a broad definition of "facilities,"<sup>263</sup> there is an argument that, in the absence of a specific cost principle, the "special circumstances" exception to the cost principle should govern, and equity dictates that the government participate in the cost of remediation if contract requirements were followed and no laws were broken.<sup>264</sup>

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<sup>261</sup> *Id.*

<sup>262</sup> It is interesting to note that DCAA, in referencing the various cost principles applicable to environmental costs, did not list FAR 31.205-31 or 31.205-24.

<sup>263</sup> FAR 31.205-31 does not define "facilities." However, FAR 45.301 provides the following definition:

"Facilities," as used in this subpart and when used in other than a facilities contract, means property used for production, maintenance, research, development, or testing. It includes plant equipment and real property (see 45.101). It does not include material, special test equipment, special tooling, or agency-peculiar property.

<sup>264</sup> Alston & Williams, *The Impact of the New Defense Business Environment on the*  
(Continued next page . . .)



Most government contracts include the Government Property clause<sup>265</sup> under which the government retains title to all government-furnished property, which has been interpreted to include scrap and waste.<sup>266</sup> The Government Property clause provides that the contractor will not be liable for any loss or damage to government property provided under the contract, or for expenses incidental to such loss or damage.<sup>267</sup> However, the contractor remains responsible for loss or damage resulting from the willful misconduct or lack of good faith of the contractor's directors, officers, or managers and supervisors.<sup>268</sup> In addition, the contractor is liable for losses attributable to risks required to be insured under the contract as well as for damage for which the contractor is otherwise responsible as provided by contract.<sup>269</sup> Under these provisions, a contractor might argue, to the extent its cleanup includes removal of anything that falls within the clause's broad definition of government property, the associated remediation costs should be allowable.<sup>270</sup>

However, it must be noted the Government Property clause also provides that the government may abandon any property in place with no further obligations.<sup>271</sup> Although

(. . . continued from last page)

*Cost Principles: Recommendations for Change*, COSTS, PRICING & ACCT. REP. 3, 6 (Aug. 1994).

<sup>265</sup> FAR 52.245-5; *see also*, FAR 52.236-7, required in cost-reimbursement construction contracts, wherein the contractor is responsible for all damages occurring as a result of the contractor's fault and negligence.

<sup>266</sup> *See, National Metal Moulding Co. v. United States*, 76 Ct. Cl. 194 (1932).

<sup>267</sup> *See*, FAR 52.245-5(g)(1).

<sup>268</sup> *See*, FAR 52.245-5(g)(2) and (3).

<sup>269</sup> *See*, FAR 45.103(b); 52.245-8. *See also*, Seymour, *supra*, note 78, at 536.

<sup>270</sup> *See*, Efron & Engel, *supra*, note 14, at 11. For instance, this cost principle might apply to a PCB spill from a transformer provided as government furnished property. *See also, ELF Atochem v. United States*, 833 F. Supp. 488 (E.D. Pa. 1993) (defendant's motion for summary judgment denied where DDT manufactured under government control created liability).

<sup>271</sup> *See*, FAR 52.245-5(j).

this authority appears to undercut any allowability argument based on the Government Property clause, contractors can argue this option does not limit the express allowability provisions of FAR 31.205-31. For this argument to prevail, FAR 31.205-31 must be interpreted to allow reconversion and rehabilitation costs regardless of who retains title to the pollutants at issue.<sup>272</sup>

#### **j. Taxes (FAR 31.205-41)**

Until late-1990, the allowability of the tax imposed on companies under CERCLA had been an issue of much contention. The DCAA had taken the position that tax was an unallowable income tax under the Taxes cost principle, FAR 31.205-41. Contractors argued it was not an income tax but instead was levied to fund Superfund cleanups, and taxable income was used only as a measure to distribute the burden of the tax equitably.<sup>273</sup> In December 1990, FAR 31.205-41 was amended to make the Superfund tax an allowable cost under government contracts "as a matter of public policy."<sup>274</sup>

The amendment did not close the books on the issue. DCAA's position is that the Superfund tax remains unallowable for any contract entered into before the promulgation of Federal Acquisition Circular 90-3.<sup>275</sup> Despite explanatory language stating the amendment was intended to "recognize" the Superfund tax as an allowable cost, DCAA treats the amendment of the cost principle as a change with only prospective application.<sup>276</sup>

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<sup>272</sup> See, Efron & Engel, *supra*, note 14, at 11.

<sup>273</sup> *Id.*

<sup>274</sup> See, Federal Acquisition Circular 90-3, 55 Fed. Reg. 52782 (Dec. 21, 1990). See also, *Regulatory Report*, Costs, Pricing & Acct. Rep. 31 (Jan. 1991). The change is found at FAR 31.205-41(a)(4).

<sup>275</sup> DCAAM, *supra*, note 147, ¶ 7-1409.

<sup>276</sup> See, Efron & Engel, *supra*, note 14, at 11.

To date, DCAA's position has not been tested before a board of contract appeals or a court. The Director of Defense Procurement, however, issued a memorandum that appears to support DCAA's interpretation regarding Superfund taxes incurred during the "window period" between the 1986 inception of the tax and the January 22, 1991 effective date of the amendment to FAR 31.205-41.<sup>277</sup> Specifically, the memorandum states DOD's Assistant General Counsel (Logistics) has advised, "the Superfund tax is a tax on income and should be treated accordingly under contracts incorporating the regulation prior to its change."<sup>278</sup>

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<sup>277</sup> Superfund Tax, Memorandum from E. Spector, Director, Defense Procurement, to Asst. Director, Policy and Plans, DCAA (Feb. 3, 1992).

<sup>278</sup> *Id.*

#### IV. THE DRAFT ENVIRONMENTAL COST PRINCIPLE

The language of the draft cost principle is analyzed here.

##### A. FAR 31.205-9(a)

(a) Environmental costs--

(1) Are those costs incurred by a contractor for:

(i) The primary purpose of preventing environmental damage; properly disposing of waste generated by business operations; complying with environmental laws and regulations imposed by Federal, State, or local authorities; or

(ii) Correcting environmental damage.

(2) Do not include any costs resulting from a liability to a third party.

This definitional subsection is significant. First, for a cost principle intended to be comprehensive, it does not expressly address whether environmental costs include prevention or remedial costs that are not legally compelled; for example, corporate self-auditing program costs.

More controversial is the exclusion of costs arising from third party liability--arising, perhaps, from groundwater contamination.<sup>279</sup> The language of the exclusion suggests third party liability would not be considered under the draft cost principle, but considered under other existing cost principles. However, DCAA's position is that environmental costs resulting from third party liability are unallowable. Their guidance states:

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<sup>279</sup> The *ad hoc* group that drafted the language of the draft cost principle was quite concerned about the language of FAR clause 52.228-7, "Insurance--Liability to Third Person," and the potentially enormous budgetary impact of its application. See, Environmental Cost Principle (DAR Case 91-56, CAAC Case 90-101), Memorandum for Col. N. Ladd, Director Defense Acquisition regulations System and A. Vicchiolla, Chairman, CAAC (undated) (hereinafter "*Ad Hoc* Committee Memorandum"). Find the pertinent text of the clause at p. 16, *supra*.

[T]hird party claims arise from legal theories of tort and trespass, and losses from such claims would be unreasonable in nature for payment on a government contract. . . . In the absence of a specific court finding of tort or trespass by the contractor, the facts of each case should be carefully examined to determine if any contractor payments are nonetheless based on those or other fault-based legal theories.<sup>280</sup>

The assumption here is a contractor could only be liable to a third party if it engages in unreasonable, tortious conduct. This disregards the possibility of risk allocation based not on negligence, but on strict liability--such as ultrahazardous activity.<sup>281</sup>

There has been criticism this exclusion would operate to the detriment of both the government and its contractors.<sup>282</sup> As a general rule, coverage under comprehensive liability policies is available only if there is liability to a third party. Thus, under the draft rule, any contractor that seeks to recover cleanup costs from the government would tacitly admit the costs did not result from a liability to another party. This acknowledgment would then likely be cited by insurance companies as a reason for denying recovery under policies not triggered absent some liability to a third party.<sup>283</sup> Thus, the concern is an evidentiary one. The government, as the argument goes, would in turn lose its ability to assert a credit for insurance recoveries as a vehicle to compensate it for costs it allowed.<sup>284</sup>

## **B. FAR 31.205-9(b)**

**(b) Environmental costs in paragraph (a)(1)(i) of this subsection, generated by current operations, are allowable, except those resulting from violation of law, regulation, or compliance agreement.**

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<sup>280</sup> DCAAM, *supra*, note 147, ¶ 7-1920.12.

<sup>281</sup> See, W. PROSSER & W. KEETON, THE LAW OF TORTS 534 (5th Ed. 1984).

<sup>282</sup> See, ABA Comments, *supra*, note 131; see also, Efron & Engel, *supra*, note 14.

<sup>283</sup> See, Efron & Engel, *supra*, note 14, at 9.

<sup>284</sup> *Id.*

This subsection generally makes compliance costs allowable. The stated exception, however, makes compliance costs unallowable if the result of a violation of law, regulation or compliance agreement. Therefore, the costs to comply with a notice of violation, for instance, would be unallowable since the costs would be incurred as a result of the violation prompting the informal enforcement mechanism.

### **C. FAR 31.205-9(c)**

**(c) Environmental costs in paragraph (a)(1)(ii) of the subsection, incurred by the contractor to correct damage caused by its activity or inactivity, or for which it has been administratively or judicially determined to be liable (including where a settlement or consent decree has been issued), are unallowable, except when the contractor demonstrates that it:**

- (1) Was performing a Government contract at the time the conditions requiring correction were created and performance of that contract contributed to the creation of the conditions requiring correction;**
- (2) Was conducting its business prudently at the time the conditions requiring correction were created, in accordance with then-accepted relevant standard industry practices, and in compliance with all then-existing environmental laws, regulations, permits and compliance agreements;**
- (3) Acted promptly to minimize the damage and costs associated with correcting it; and**
- (4) Has exhausted or is diligently pursuing all available legal and contributory (e.g., insurance or indemnification) sources to defray the environmental costs.**

This is, of course, the heart of the controversy. The effect of this subsection is to disallow otherwise reasonable costs. As a general matter, the contractor has the burden of proving the reasonableness of incurred costs if challenged.<sup>285</sup> However, the long-standing rule is the government has the burden of proving a specific disallowance is applicable.<sup>286</sup> The effect of this turnabout of presumptions is difficult to predict.

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<sup>285</sup> See, FAR 31.201-3(a).

<sup>286</sup> See, e.g., *Lockheed-Georgia Co.*, *supra*, note 181, at 115,276.

The requirements that the contractor was performing a government contract at the time of the pollution and that the performance of the contract contributed to the condition are contrary to the allocability rules. The proper test is whether a cost objective is benefited by the costs, or whether the costs are necessary to the overall operation of the business.<sup>287</sup> The proposed rule would have little effect on the allocation of direct costs of performance, since there is a direct relationship between the costs and a government contract by definition.<sup>288</sup> Indirect costs benefiting more than one contract or cost objective would also be allowable under this provision. However, G&A costs necessary to the overall operation of the business, the category in which cleanup costs typically fall, would not be allowable if the pollution did not occur during and from the performance of a government contract--even though absolutely necessary to overall business operations.<sup>289</sup>

The requirement the contractor be acting prudently at the time of the pollution, consistently with then-applicable industry standards and environmental laws, and promptly to minimize the damage and associated costs is essentially a definition of reasonableness the contractor would have the burden of demonstrating if challenged. The provision adds little to the "reasonableness" definition in FAR Part 31, or the body of case law applying that standard--and would still require a case-by-case analysis.

This last clause puts the contractors in a "Catch-22." Cleanup costs will be disallowed unless the contractor has exhausted or is diligently pursuing all available legal and contributory sources, presumably to include the United States--regardless whether doing so is reasonable. Costs of these pursuits could be disallowed as unreasonable when

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<sup>287</sup> See, pp. 40-43, *supra*.

<sup>288</sup> See, FAR 31.201-4; *see also*, pp. 41-42, *supra*.

<sup>289</sup> *Id.*

futile. There is also no answer to the question how long these contributory sources should be pursued. Costs allowed in one accounting period, might be disallowed in another.

#### **D. FAR 31.205-9(d)**

**(d) In cases where the current owner is required to correct environmental damage which was caused by the activity or inactivity of a previous owner, user, or other lawful occupant of an affected property, the resulting environmental costs are unallowable, except where the current contractor demonstrated that:**

**(1) The previous owner, user, or other lawful occupant's actions satisfy the criteria in paragraphs (c)(1) through (3) of this subsection and**

**(2) The current contractor has complied with paragraphs (c)(3) and (4) of this subsection during the period that it has owned, used, or occupied the property.**

This subsection implicitly acknowledges that the contractor can incur cleanup costs solely from the incident of ownership. The comments regarding the previous subsection are equally applicable here. Including the language incorporated by reference, this subsection states costs will be disallowed unless the previous owner was performing a government contract at the time the conditions requiring correction were created and performance of that contract contributed to the creation of the conditions requiring correction; was conducting its business prudently at the time the conditions requiring correction were created, in accordance with then-accepted relevant standard industry practices, and in compliance with all then-existing environmental laws, regulations, permits and compliance agreements; and acted promptly to minimize the damage and costs associated with correcting it. Additionally, the contractor must also have acted promptly to minimize the damage and costs associated with correcting it; and have exhausted or is diligently pursuing all available legal and contributory (e.g., insurance or indemnification) sources to defray the environmental costs. Even though the contractor would have less



culpability in the pollution, its burden is greater. Indeed, it may be impossible to prove what happened long ago.

The drafters might have had in mind the possibility of a contractor buying "dirty" property, cleaning up with government subsidies, and selling at a profit. This scenario is addressed by the principles of capitalization.<sup>290</sup> However, it is inherently unfair a contractor that bought clean property and "legally" contaminated it is reimbursed cleanup costs, and another contractor who unwittingly brought dirty property many years ago and did not contribute to the contamination is denied reimbursement.

#### **E. FAR 31.205-9(e)**

**(e) However, paragraphs (c) and (d) of this subsection do not apply to costs incurred in satisfying specific contractual requirements to correct environmental damage (e.g., where the Government contracts directly for the correction of the environmental damage at a facility which it owns).**

This subsection is refers to RACs or cleanup contractors. Indemnity in limited circumstances might be provided to contractors with cleanup awards under CERCLA section 119, or Pub. L. 85-804. In any event, the cleanup costs limitation in the proposed cost principle would not apply to such contractors.

#### **F. FAR 31.205-9(f)**

**(f) Increased environmental costs resulting from the contractor's failure to obtain all insurance coverage specified in Government contracts are unallowable.**

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<sup>290</sup> Costs incurred to fix up property held for sale are to be capitalized, if such costs are realizable from the sale. In the case of costs in excess of realizable costs, the excess amounts are expensed or capitalized depending on whether they improved the property beyond the property's condition at acquisition. See, DCAAM, *supra*, note 147, ¶ 7-1920.8(c); see also, discussion at pp. 86, *infra*.

This provision does not evoke much controversy. Contractors would rarely, if ever in today's market, be directed to obtain Environmental Impairment Liability insurance coverage. Also, the draft principle only makes unallowable the "increased costs" of not obtaining required policies. Issue may arise, however, if a contractor did not acquire specified coverage during the years before environmental damage exclusions were written into comprehensive general liability policies.<sup>291</sup>

#### **G. FAR 31.205-9(g)**

**(g) Costs incurred in legal and other proceedings, and fines and penalties resulting from such proceedings are governed by [FAR] 31.205-47 and 31.205-15, respectively.**

This last subsection provides nothing more than an acknowledgment the previously discussed cost principles apply.

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<sup>291</sup> See, p. 17, *supra*.

## V. CURRENT DEVELOPMENTS

### A. The Judiciary

The judiciary, including the agency boards of contract appeals, have not decided any cases involving the allowability of specific environmental costs. Disputes have arisen, but have been negotiated and settled. These disputes are nevertheless illustrative of the variety and dimension of environmental costs contractors incur, and shall be discussed, *infra*.<sup>292</sup>

### B. The Executive

#### 1. DCAA

##### a. 1992 DCAA Guidance

DCAA issued audit guidance for environmental costs on October 14, 1992.<sup>293</sup> This guidance, developed in coordination with the office of the Director of Defense Procurement, stated in the precatory language that environmental costs were to be treated as normal business expenses and generally allowable if reasonable and allocable.<sup>294</sup>

"Environmental costs" were defined as, "costs to prevent environmental contamination, costs to clean up prior contamination, and costs directly associated with the first two categories including legal costs."<sup>295</sup> "Normal business expenses" were defined

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<sup>292</sup> See, pp. 92-109, *infra*.

<sup>293</sup> See, 1992 Guidance, *supra*, note 158; see also, *DCAA Audit Guidance Calls for Treating Environmental Costs as Normal Business Expenses*, 58 FED. CONT. REP. (BNA) 470 (1992). Note that the Department of Energy uses provisions found at DOE FAR Supp. Subpt. 790.31 in lieu of the FAR Part 31 cost principles for its Maintenance and Operations contracts.

<sup>294</sup> See, 1992 Guidance, *supra*, note 158, at 1.

<sup>295</sup> *Id.*

as, "those expenses that an ordinary, reasonable, prudent businessperson would incur in the course of conducting a competitive for-profit enterprise."<sup>296</sup> In the context of environmental costs, normal business expenses are measured by the actual costs incurred in the period.<sup>297</sup>

#### **i. Reasonable Costs**

With regard to reasonableness, the 1992 Guidance states:

The key concept for reasonableness of environmental costs (both preventive and remedial) is that the methods employed and the magnitude of the costs incurred must be consistent with the actions expected of an ordinary, reasonable, prudent businessperson performing non-Government contracts in a competitive marketplace. A Government contractor should take measures to prevent or reduce contamination which a prudent businessperson would pursue to reduce its environmental costs.

Determination of reasonableness of clean up costs also requires an examination of the circumstances of the contaminating event. Contractors should not be reimbursed for increased costs incurred in the clean up of contamination which they should have avoided. In order to be allowable, contamination must have occurred despite due care to avoid the contamination, and despite the contractor's compliance with the law. Increased costs due to contractor delay in taking action after discovery of the contamination are not allowable. For forward pricing purposes, the costs should be net of reasonable available recoveries from insurance which would offset the clean up costs.<sup>298</sup>

The DCAA guidance called for the auditor to make two decisions: a "due care" determination concerning the contractor's preventive measures, and a legal determination the contractor had complied "with the law." Clearly, the "due care" aspect inserted a fault-based, tort law requirement to be met, as well as the legal compliance requirement.

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<sup>296</sup> *Id.*

<sup>297</sup> *Id.*

<sup>298</sup> *Id.*, at 2.

A contractor's failure to meet either one meant its environmental costs were not "reasonable."<sup>299</sup> The guidance continued:

If environmental cleanup costs are the result of contractor violation of laws or regulations, or disregard of warnings for potential contamination, the clean up costs including any associated costs, such as legal costs, would be unreasonable, and thus unallowable. Fines or penalties are expressly unallowable under FAR 31.205-15 and any costs of legal proceedings where a fine or penalty could be imposed are covered by FAR 31.205-47. (Note, the incurrence of clean up costs to correct environmental contamination is not a penalty; it is a legal obligation.) However, most of the laws do not require the contractor to be guilty of violation to enforce contractor payment for clean up costs. Therefore, it is rare for Government agencies to bring criminal, or even administrative, charges for contamination. Contractors should be requested to produce documents sufficient to allow a determination as to how the contamination occurred.<sup>300</sup>

## **ii. Allocable Costs**

The following pertinent passage from the 1992 Guidance addressed cost allocability:

Costs incurred to prevent environmental contamination will generally be allocated as an indirect expense using a causal or beneficial base. Costs to clean up environmental contamination caused in prior years will generally be period costs. In accordance with CAS 403 cleanup up costs should be allocated to the segment(s) associated with the contamination which in turn should allocate the costs to contracts as part of the segment residual G&A [or general and administrative] costs under CAS 410.<sup>301</sup>

Contrary to the language of the draft cost principle, the audit guidance did not require environmental damage be caused in, or during, the performance of a government contract, if the costs are properly allocable and charged to the proper period. Whether this is another way of saying cleanup costs are "absolutely necessary," and therefore no

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<sup>299</sup> See, McDonald & Isaacson II, *supra*, note 11, at 631.

<sup>300</sup> *Id.*, at 5.

<sup>301</sup> *Id.*, at 2.

benefit or causation analysis is required, remains an open question.<sup>302</sup> The guidance further provided:

If costs arise from a site the contractor segment previously occupied, the costs for clean up would usually be allocated to the segment's site where the work was transferred. However, if the segment is closed with none of its former work remaining within the company, the cost would generally not be directly allocable to other segments of the business. There are many possible variations for the costs accounting treatment of environmental costs for a closed segment, depending on the facts of the particular situation. Information we would consider includes:

1. Are any aspects of the closed segment's business being continued by the remaining segments?
2. Is the site still owned by the contractor? If it is, what is its current use?
3. If the site is not now owned by the contractor, what were the terms of the sale in relation to environmental costs? The contractor may have retained environmental cleanup liability in exchange for a higher sale price or the buyer may have accepted full liability in exchange for a lower purchase price.

Each closed segment case must be reviewed based on its own facts to determine if the costs incurred for the closed segment should be directly allocated to other segments, be allocated as residual home office costs, or be treated as an adjustment of the extraordinary costs associated with the closing of the segment.<sup>303</sup>

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Generally Accepted Accounting Principles in the Emerging Issues Task Force (EITF) Issue No. 90-8 indicates that environmental costs would normally be expensed in the period unless the costs constitute a betterment or an improvement, or were for fixing up property held for sale. Betterments and improvements which exceed the contractor's capitalization threshold must be capitalized. Costs of fixing up a property for sale are generally considered to be part of the sales transaction, if realizable from the sale. It would be unreasonable for the Government to accept as current period costs, expenditures which increase the value of contractor assets;

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<sup>302</sup> See, Nilsson, *supra*, note 97.

<sup>303</sup> 1992 Guidance, at 2.

accordingly, these costs should be capitalized for Government contract costing purposes. The EITF discusses situations where capitalization of the expenditure may be appropriate.

First, cost incurred to clean up a site should be capitalized if it improved the property beyond the original condition of the property at acquisition. The costs incurred to restore a property to its acquisition condition are generally expensed unless they extend the property's useful life. Second, costs incurred to fix up property held for sale are to be capitalized, if such costs are realizable from the sale. A contractor may be required to incur contamination clean up costs far in excess of any amount reasonably realizable upon sale. In the case of costs in excess of realizable costs, the excess amounts are expensed or capitalized depending on whether they improved the property beyond the property's condition at acquisition. Third, costs incurred to prevent future contamination would have an economic value in more than one period and should be amortized over their useful life. Capital assets purchased or constructed to prevent future contamination must be capitalized consistent with CAS 404 and GAAP.

Examples:

1. A contractor acquires property which was contaminated by a previous owner. Clean up costs are capitalized as an improvement. Costs of ground and water clean ups are increases to the book value of the land.
2. A contractor cleans up contamination from its own operations since acquiring the property. If the property is being held for continuing use, the costs are expensed as period costs.
3. If a contractor incurs \$80 million dollars [*sic*] in costs to clean up a site which is being held for sale and has a book value of \$50 million dollars [*sic*], so that it can be sold for \$500 million dollars [*sic*] the \$80 million is realizable and should be capitalized. If the sales price had been \$50 million, none of the \$80 million would be realizable and it should be expensed in the period.
4. Costs which benefit future periods by preventing future environmental contamination should be capitalized and written off over the future periods.<sup>304</sup>

This guidance concerning the proper period of allocation neglects the requirement for a showing of benefit to a government cost objective. On this point, recall remediation

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<sup>304</sup>

*Id.* at 3.

costs are assessed without regard to whether the imposition of liability on particular parties is warranted. Under applicable environmental laws, the process for identification of PRPs is generally unrelated to questions of equity. On the contrary, its appeal lies largely in the ease of administration for regulatory authorities over the question of who pays. Accordingly, there is no logical basis for requiring a nexus between a government contract and the contamination being remediated. Unless the government contractor has engaged in improper conduct, there is no justification for excusing the federal government from costs payable by any other customer of that contractor. Stated another way, commercial customers do not receive a price reduction because they do not benefit from some past activity that created the contamination. A government contractor's remediation costs are assessed in a manner similar to a targeted tax, and are therefore merely another ordinary and necessary cost of doing business.<sup>305</sup> In the case of mandatory payments such as taxes or assessments, a showing of "general benefit" to the contract was sufficient for allocation.<sup>306</sup> Many EPA or court ordered cleanup costs fit into this category. However, voluntary cleanup costs and cleanup of wastes unrelated to past or present government contracts might not have the sufficient connection or benefit to be allocable to the government. To be consistent with existing case law, allocation of a contractor's cleanup costs to government contracts should not be automatic. There should be some showing of the absolute necessity of the expense or a benefit to the government contract.<sup>307</sup>

### **iii. Allowable Costs**

The remaining portions of the 1992 Guidance follow:

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<sup>305</sup> See, McDonald & Isaacson II, *supra*, note 11, at 633.

<sup>306</sup> See, *Lockheed Aircraft Corp. v. United States*, *supra*, note 163.

<sup>307</sup> See, Nilsson, *supra*, note 97.



The environmental laws usually require each Potentially Responsibility Party (PRP) for contamination at a site to be individually liable for the complete clean up of the site. The allowable environmental cost should only include the contractor's share of the clean up costs based on the actual percentage of the contamination attributable to the contractor.

If the Government accepted costs based on ability to pay, a Government contractor could end up billing a disproportionate share of the clean up costs to Government contracts instead of recovering the excess payments from other PRPs. If the Government contractors pay a disproportionate amount, the funds will just transfer from one Government appropriation to another, with some PRPs not paying their share.

Where the contractor paid for more than its share of the site clean up, the contractor receives a right of contribution (or subrogation) against the other PRPs who did not make an appropriate contribution to the clean up effort. If the contractor pays out more than its share of clean up costs, it is up to the contractor to exercise its contribution rights to collect the amount over its share from the other PRPs who did not pay their share.

If a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are, in their essential nature, bad debts. Bad debts and associated collection costs, including legal fees, are unallowable costs (FAR 31.205-3 and 31.204(c)).<sup>308</sup>

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The insurance industry does not currently consider environmental contamination an insurable risk (at a reasonable cost) in most circumstances. The major exception is a sudden accidental contamination, such as an oil tanker spill resulting from a collision. If such insurance is available and reasonably priced, its cost would be allowable.

However, some courts have found that policies written before the insurance industry began to exclude environmental coverage do afford coverage for environmental damages. Any insurance recoveries for a contamination clean up will be applied as credits against any costs which were or would be otherwise allowable for that clean up effort.

Many environmental contamination events now generating costs were insured, either under specific environmental impairment or comprehensive general liability coverages, before the insurance industry developed its current underwriting exclusions. It is the earlier insurance policies which are the source of the potential claims. Most insurance companies are

<sup>308</sup>

1992 Guidance, at 4.

contesting the claims and when payments are made, they are based on partial settlement or after lengthy legal battles. Where a claim is possible and economically feasible, the contractor should pursue it. In any case, the Government should inquire about the existence of environment contamination policies and comprehensive general liability policies which do not contain environmental clean up cost exclusions. The kind and amount of policies in effect from the time of the contamination to the current date are significant for the purposes of negotiating costs and prices for Government contracts. The contractor's support for proposed clean up costs should include a description of any insurance claim the contractor may have which could reduce the ultimate liability. The amount and timing of these claims for contract costing is a potential subject for negotiation which should be addressed by the auditor and ACO [Administrative Contracting Officer].<sup>309</sup>

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Examples of liability to third parties include health impairment, property damage, or property devaluation for residents or property owners near a contaminated site. These third party claims arise from legal theories of tort and trespass, and losses from such claims would be unreasonable in nature for payment on a Government contract. In the absence of a specific court finding of tort or trespass by the contract, the facts of each case should be carefully examined to determine if the contractor payments are none-the-less based on those or other fault based legal theories.<sup>310</sup>

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There are many areas of judgment involved in the determination of allow-ability for environmental costs. It is necessary for the auditor and the ACO to coordinate closely during the review. Advance agreements should be considered to facilitate negotiations with the contractor.

Ideally, the Government wants to negotiate costs and prices based on the net environmental costs after application of incurrence claims. At the time that environmental costs are being incurred, it may not be possible to reasonably estimate what the net costs will be. Even where it is settled that a contractor will be required to clean up a prior contamination, it is rare that projections of the costs necessary to complete the project can be made with a reasonable degree of certainty. Due to the uncertainty of the cost projections and the uncertainty of future recoveries from the insurance companies, environmental clean up costs are contingent costs subject to FAR 31.205-7 for both incurred cost settlements and forward pricing. Acceptance of the costs may require some form of agreement to protect the

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<sup>309</sup> *Id.*, at 4-5.

<sup>310</sup> *Id.*, at 5.

Government's interest. Any agreement to accept costs for clean up or the costs of insurance recovery efforts as current expenses should also provide expressly for Government participation in any insurance claim recoveries.<sup>311</sup>

### **b. DCAA/DCMC Joint Pilot Study**

In May 1993, DOD decided more information regarding the treatment of contractors' environmental costs was needed to determine what changes, if any, to the draft cost principle were appropriate.<sup>312</sup> With this in mind, a review of environmental costs was directed for five named sites--one in each DCAA region and DCMC district.<sup>313</sup> This review was to be conducted jointly by representatives of DCAA and DCMC. The five sites were General Electric in Burlington, Vermont; the Martin Marietta Corporate Office in Bethesda, Maryland; Pratt & Whitney in West Palm Beach, Florida; the Thiokol Corporate Office in Brigham City, Utah; and FMC Ground Systems Division in Santa Clara, California. The regional reports were to be consolidated at DCMC Headquarters, and a final report forwarded to the Office of Defense Procurement.<sup>314</sup>

### **c. 1994 DCAA/DCMC Guidance**

On April 13, 1994, new guidance on environmental costs was issued jointly by DCAA and DCMC.<sup>315</sup> This guidance was intended to amplify the 1992 Guidance and

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<sup>311</sup> *Id.*, at 5-6.

<sup>312</sup> *DOD to Revisit Draft FAR Cost Principle, Will Reassess Government's Fair Share of Costs*, 59 FED. CONT. REP. (BNA) 681 (1993).

<sup>313</sup> *DCAA, DCMC Announce Pilot Audit Program to Develop Guidance on Allowable Costs*, *supra*, note 114.

<sup>314</sup> *See*, McDonald & Isaacson II, *supra*, note 11, at 631.

<sup>315</sup> Defense Contract Management Command and Defense Contract Audit Agency, *Guidance Addressing Questions Raised Related to the October 14, 1992 Guidance Paper on Environmental Costs, Memorandum for Environmental Pilot Teams* (April 13, 1994), *reprinted in*, GOV'T. CONT. REP. (CCH) ¶ 99,855 (July 6, 1994) (hereinafter "1994 Guidance").

address specific accounting issues raised by the pilot study teams. The pilot teams posed in the form of questions 14 issues in need of guidance. The questions concerned capitalization, property held for sale, other PRPs, calculation of the contractor's share of allowable costs, allocation of costs of past environmental contamination, allocation of compliance costs, and environmental wrongdoing.<sup>316</sup>

The 1994 Guidance stated costs of cleaning up property contaminated after it was acquired are analogous to repair costs and should be charged to current period expenses under CAS 404. Capitalization is appropriate for costs incurred to acquire property or equipment designed to remediate or contain environmental contamination. Costs of preparing property for sale may be capitalized to the extent the sales price exceeds the book value of the property. Costs incurred to cleanup property already contaminated when acquired should be capitalized as an improvement to the land to the extent total book value does not exceed the fair market value of the property.<sup>317</sup> However, costs incurred to comply with a regulatory agency's order or to make property safe for a contractor's normal operations may not be classified as costs of preparing a property for sale.<sup>318</sup>

Costs of cleaning up past contamination are normally G&A costs<sup>319</sup> because they have no clear and measurable causal or beneficial relationship with cost objectives of the current period. However, if such a relationship exists, cleanup costs may be allocated as

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<sup>316</sup> The 1994 Guidance has essentially been incorporated with the 1992 Guidance in the DCAAM, *supra*, note 147, Subpart 7-1920.

<sup>317</sup> See, 1994 Guidance, *supra*, note 315. This guidance seems inappropriate in the instance of a contractor unwittingly purchasing contaminated property without discount many years ago.

<sup>318</sup> See, *Id.*

<sup>319</sup> See, CAS 410, *supra*, note 171.

other than G&A.<sup>320</sup> On the other hand, compliance costs such as costs incurred to comply with permits required for hazardous waste storage facilities should be allocated on a CAS 418 causal or beneficial basis.<sup>321</sup>

Consistent with the 1992 Guidance, the pilot study teams were informed that costs for cleanup of contamination caused by other parties that are uncollectible from the other PRPs are unallowable because they are in the nature of bad debts. These costs are not bad debts strictly speaking, in that the contribution amounts the contractor would seek from other PRPs are in the nature of a claim rather than accounts receivable or a liquidated debt. However, under FAR 31.204(c), allowability is determined by the regulatory provision that best captures the essential nature of the cost at issue.<sup>322</sup>

Costs incurred for cleanup of contamination caused by other parties may be allowable if the parties responsible for the contamination are no longer in business. The costs should not be characterized as bad-debt expenses if there is no one against whom the contractor can take legal action. However, if the other party is still in existence, or a successor company has assumed its liability, then cleanup costs attributable to that party's actions are, if uncollectible, in the nature of bad debts.<sup>323</sup>

Costs of environmental cleanup are the result of a violation of environmental law if the contamination resulted from a contractor's acts that did not comply with the specific

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<sup>320</sup> See, CAS 418, *supra*, note 172.

<sup>321</sup> See, 1994 Guidance, *supra*, note 315. This would presumably not include RCRA corrective action (cleanup) costs. Since the 1984 HSWA amendments to RCRA, *supra*, note 66, all facilities issued a RCRA permit must take corrective action for contamination at or from the facility, including releases from past disposal. See, RCRA § 3004(u), 42 U.S.C. § 6924(u). Whether corrective action costs are compliance costs or cleanup costs remains, however, an open question.

<sup>322</sup> *Id.*; see also, discussion on p. 48, *supra*.

<sup>323</sup> See, 1994 Guidance, *supra*, note 315.

requirements imposed by laws, regulations, orders, or permits. A violation can occur without a formal citation by a governmental agency. Under the 1994 Guidance, it is not necessary to make a legal determination in gray areas of the law to determine whether a contractor's practice was not consistent with the actions expected from a reasonable, prudent business person. Similarly, the contamination would be a result of a disregard for potential contamination if the contractor had warning from any competent source--including internal safety reviews.<sup>324</sup>

Cleanup costs for a plant that was contaminated when acquired and was never used would be questioned as costs of idle facilities under FAR 31.205-17. Thus, it would be irrelevant whether the property was being held for sale and thus within the class of cleanup costs that should be capitalized.<sup>325</sup>

#### **d. DCAA/DCMC Joint Pilot Study Concluded**

Presently, all the regions have submitted their reports. The final report was submitted to Ms. Spector earlier this year and is expected to have stated the allowability of environmental costs at the five locations varied widely.<sup>326</sup> Such a conclusion would not be unexpected, due to the fact the costs examined arose under different types of contracts, different factual circumstances (type of contamination, nature of remediation methodology, extent of preventive measures, and so on), were accounted for differently, and were evaluated by different contracting offices in different agencies.<sup>327</sup> Environmental cost must be handled on a case-by-case basis. What conclusion might be drawn from the

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<sup>324</sup> *See, Id.*

<sup>325</sup> *See, Id.*

<sup>326</sup> *See, Id.*

<sup>327</sup> *See, Id.*

findings of the report is not yet known. The report might have recommended the promulgation of a revised environmental cost principle to promote uniformity of treatment. On the other hand, it might have recommended there be no environmental cost principle at all; *i.e.*, that the allowability of environmental costs be considered under the existing FAR cost principles. The joint task force could even have recommended other regulatory or statutory initiatives, such as modifications to existing cost principles, or, where possible, addressing environmental cost issues pre-award. While the details of the report are largely unknown,<sup>328</sup> government sources confirmed the report shows that treatment of environmental costs at the different contractor sites varied.<sup>329</sup> Ms. Spector was briefed on the final report this spring and returned the issue of the environmental costs treatment to the DAR Council for action.<sup>330</sup>

## **2. Related Agency Developments**

The field of government contracts was not the only one in which the treatment of environmental costs has been closely examined. Another area where the implications of such costs were considered was tax deductibility. Although Internal Revenue Service ("IRS") treatment of remediation costs is not directly applicable to the cost allowability question under government contracts, the identification of these costs as an ordinary and necessary business expense was a difficult and complex issue for that agency as well.

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<sup>328</sup> No one outside the government has seen the report, and Freedom of Information Act requests for the report have been denied.

<sup>329</sup> See, McDonald & Isaacson II, *supra*, note 11, at 631.

<sup>330</sup> *Spector Orders DAR Council to Reopen Environmental Cost Principle Case in Light of DCAA*, *supra*, note 116.

By late 1993, the IRS had initially concluded in several private rulings that environmental costs were not deductible as ordinary and necessary business expenses.<sup>331</sup> In November 1993, the Treasury Department announced a task force had been formed to explore the tax treatment of environmental remediation costs. From a policy perspective, the Administration apparently was seeking to avoid litigating as many remediation cost cases as possible.<sup>332</sup> The IRS recognized that such costs should not always be capitalized, and any credible ruling would have to allow these costs to be deductible as business expenses in some cases.<sup>333</sup> In June 1994, the IRS issued Revenue Ruling 94-38 to provide guidance on the tax treatment of contamination cleanup costs in a basic remediation scenario. The ruling indicated that certain costs associated with surface and groundwater pollution were deductible under section 162 of the Internal Revenue Code.<sup>334</sup> For government contractors, the importance of this ruling was the IRS did not view these costs as extraordinary expenses requiring special treatment. To the contrary, these costs were ordinary and necessary business expenses to be deducted when paid.<sup>335</sup> To Representative Synar's Mr. and Mrs. Smith, the impact of the ruling is that they would have less environmental cost impact causing increased prices or reduced profits.

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<sup>331</sup> See, McDonald & Isaacson II, *supra*, note 11, at 629.

<sup>332</sup> See, *IRS Considering Possible Revenue Ruling on Cleanup Expenses to Reduce Litigation Costs*, 24 Envtl. Rep. (BNA) 1341 (1993).

<sup>333</sup> See, McDonald & Isaacson II, *supra*, note 11, at 629.

<sup>334</sup> 26 U.S.C. § 162.

<sup>335</sup> See, McDonald & Isaacson II, *supra*, note 11, at 629.



## C. The Legislature

### 1. Previous Congresses

#### a. Requested GAO Studies

Primarily at the behest of the House Government Operations Committee, GAO issued several reports on the subject of DOD environmental costs.<sup>336</sup> The reports substantiate that the policies and practices concerning the allowability of environmental costs varied widely within DOD, ranging from complete denial to full reimbursement. GAO concluded that, "These variations can occur because federal acquisition laws, regulations, and policies do not provide specific guidance to decision-makers on how to treat environmental cleanup costs."<sup>337</sup>

GAO focused an analysis of the environmental liabilities and costs treatment at three defense contractors: Aerojet-General, Boeing, and Lockheed.<sup>338</sup> An examination of these costs demonstrates, *inter alia*, despite the complexities and gravity of these incurred

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<sup>336</sup> United States GAO, *Information on Contractor Cleanup Costs and DOD Reimbursements*, GAO/NSIAD-92-253FS (1992); *Observations on Consistency of Reimbursements to DOD Contractors*, *supra*, note 145; United States GAO, *Unresolved Issues in Reimbursement to DOD Contractors*, GAO/T-NSIAD-93-12 (1993); United States GAO, *Too Many High Priority Sites Impede DOD's Program*, GAO/NSIAD-94-133 (1994); United States GAO, *Inconsistent Sharing Arrangements May Increase Defense Costs*, GAO/NSIAD-94-231 (1994); and *Defense Indemnification for Contractor Operations*, *supra*, note 76.

<sup>337</sup> *Observations on Consistency of Reimbursements to DOD Contractors*, *supra*, note 145; *see also*, McDonald & Isaacson II, *supra*, note 11, at 632.

<sup>338</sup> *Id.* Environmental costs of other contractors have been reported. Also mentioned in Richards & Pasztor, *Why Pollution Costs of Defense Contractors Get Paid by Taxpayers*, Wall St. J. (Aug. 31, 1992) are General Motors Corp., General Dynamics, Corp., FMC Corp., and Martin Marietta Corp. Fairchild Industries also recently filed a claim including environmental remediation costs. *See, Decisions in Brief*, 63 FED. CONT. REP. (BNA) 490 (1995).

environmental liabilities, the absence of an environmental cost principle has not diminished the parties' ability to negotiate a resolution.

**i. Aerojet-General**

Aerojet-General Corporation, the wholly owned subsidiary of GenCorp, incurred the costs that led to the Air Force's call for the draft environmental cost principle. The Aerojet case involves the company's manufacturing facilities located in Rancho Cordova, California, on the outskirts of Sacramento. The facilities are used for developing, testing, and manufacturing solid and liquid rocket motors. These activities have been conducted on the site since the 1950s. In 1979, groundwater contamination was discovered in several private wells surrounding Aerojet's 8,500-acre production site. The wells contained volatile organic compounds, including trichloroethylene--a solvent used in rocket manufacturing. Aerojet then confirmed the presence of such compounds in wells on its site. The origin of the groundwater contamination was traced to more than 250 acres on the Aerojet site. Several industrial activities near these areas contributed to the contamination of the groundwater and soil. Seven separate plumes (*i.e.*, accumulations or concentrations of chemicals) were identified in the groundwater beneath the Aerojet site. These plumes ranged from 1/2 mile to 3 miles in length. While the safe drinking water standard for trichloroethylene is 5 parts per billion, concentrations of up to 100,000 parts per billion were detected in the groundwater. In 1982, EPA listed the Aerojet site on its NPL as one of the ten highest risk sites in the United States<sup>339</sup>

In 1979, the California Attorney General filed suit to require Aerojet to stop discharging hazardous chemicals in a manner that would continue to contaminate the

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<sup>339</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 14-15.

groundwater, and to remove hazardous chemicals from the soil and groundwater. Aerojet officials reported to GAO it had already begun to implement such activities in 1979, including sealing floor drains in manufacturing buildings and transporting over 8,000 cubic yards of contaminated soil to an approved disposal site. Aerojet began construction of nine water treatment facilities to control the off-site migration of the contaminated groundwater in 1981. From 1983 to 1989, EPA, in cooperation with state agencies, negotiated with Aerojet for cleaning up the contamination pursuant to CERCLA requirements. Under a 1989 partial consent decree, Aerojet agreed to (1) complete a Remedial Investigation/Feasibility Study to determine the nature and extent of contamination and identify potential remedies and costs, (2) operate groundwater treatment facilities to prevent further off-site migration and begin removing contaminants from the groundwater, and (3) monitor private water supply wells and the nearby American River for contamination. Site investigation work is scheduled to be completed in 1996. After the site investigation is complete, EPA and the state authorities expect to determine the remedial actions required for final cleanup of the soil and groundwater contamination. Several factors, including the cost-effectiveness of different cleanup methods, will be considered in selecting the appropriate method. A final consent decree will then be negotiated to detail Aerojet's cleanup responsibilities. Final cleanup activities are expected to continue well into the next century.<sup>340</sup>

Aerojet spent nearly \$75 million on cleanup activities during the 1980-91 period GAO studied. Aerojet spent about \$53 million, or 72 percent of the total expenditures, on direct cleanup-related activities such as site investigation, sample analysis and construction

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<sup>340</sup> *Id.*, 15-16.

and operation of groundwater treatment facilities. About \$21 million was spent on indirect activities, including payments to EPA and the state for consent decree implementation and legal costs related to Aerojet's litigation with EPA, California and private parties. Aerojet estimated it would spend another \$68 million through 1996-99 to implement the partial consent decree. The cost to complete final cleanup efforts has not been determined. Aerojet does not expect the study to be completed until 1996. According to GAO, one EPA model estimates cleanup costs up to 15 times greater than the remedial investigation and feasibility study costs.<sup>341</sup>

As of November 1991, DOD had reimbursed Aerojet about \$36 million for cleanup-related expenses. This included about \$24 million paid in 1989 to settle a disputed 1986 claim for reimbursement, about \$5 million in interest, and another \$7 million reimbursed as a subcontractor on DOD contracts with Martin Marietta Corporation. Martin Marietta approved the payment through its DOD-approved purchasing system. Aerojet also received another \$3 million from other federal agencies. Aerojet submitted a claim for cleanup costs incurred after June 1989 to implement the partial consent decree. The claim was in litigation, but settled. The government payments to Aerojet have been reduced about \$6.5 million by recoveries from Aerojet's insurers. The settlement agreement required Aerojet to set aside for DOD half of any insurance recoveries and a quarter of any interest on the insurance recoveries for costs incurred through June 1989. As of July 1992, Aerojet had received about \$11 million from its insurers for certain legal costs and another \$5 million in interest.<sup>342</sup>

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<sup>341</sup> *Id.*, at 17.

<sup>342</sup> *Id.*, at 17-18.

To determine the allowability of Aerojet's cleanup costs, the contracting officer used general cost allowability criteria contained in the FAR. The contracting officer interpreted the reasonableness standard as requiring compliance with then-existing environmental laws and regulations. The contracting officer investigated Aerojet's compliance with federal, state and local environmental laws and regulations, and concluded, in his final decision denying Aerojet's claim, Aerojet had not complied with state hazardous waste discharge permits. For example, one permit issued in 1952 specifically prohibited discharges of hazardous materials, including trichloroethylene, at the Aerojet facility in a manner that would result in contamination of groundwater or the American River. After the contamination was discovered, the State Water Resources Control Board held a hearing on the disposal practices at Aerojet and also concluded the company had violated discharge permits.<sup>343</sup> When the contracting officer denied Aerojet's claim, Aerojet appealed the decision to the Armed Services Board of Contract Appeals.<sup>344</sup> In support of its claim, company officials stated the costs were ordinary and necessary business expenses, and that it had not violated the state's discharge permit because its disposal practices were in compliance with general government and industry practices, were known to and approved by the state, and were not prohibited by the permit. Company officials also stated Aerojet did not know, at the time, groundwater contamination would result from its disposal practices. DOD settled the appeal and paid about half of Aerojet's cleanup costs through June 1989. The Air Force identified several

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<sup>343</sup> *Id.*, at 18.

<sup>344</sup> *See, Aerojet-General Corp.*, ASBCA No. 34033 (*settled and dismissed*, Feb. 28, 1990); *see also, Aerojet-General Corp.*, ASBCA No. 40309 (*appeal docketed*, Feb. 2, 1990).

issues that bore on its decision to settle. The issues included whether: (1) state discharge permits were specific enough to be considered strong evidence of Aerojet's negligence (they did not require Aerojet to monitor discharges or test the groundwater for possible contamination, and did not specifically prohibit discharge of hazardous wastes to the ground); (2) some DOD contracts required the use of chemicals that contributed to the contamination (government-furnished equipment used in de-greasing operations and government-furnished materials such as propellants might have also contributed to contamination); (3) indemnification clauses in contracts between DOD and Aerojet from the 1950s to 1979 could be interpreted to include the groundwater contamination that resulted from performance of government contracts; and (4) the Navy's leasing of approximately 3,500 acres and owning about 300 buildings on the site where contamination took place. The Air Force therefore determined settlement to be in the government's best interest. Settlement minimized chances the government would have to participate in the cleanup under CERCLA as a PRP.<sup>345</sup> The EPA and state focus on obtaining Aerojet's agreement to take responsibility for the cleanup, rather than identifying potential wrongdoing, did not assist DOD's determination of allowability. EPA did not investigate Aerojet's compliance with laws and environmental regulations. In 1979, after filing the suit, the California Attorney General agreed to not pursue it if the company agreed to implement the partial consent decree. Although Aerojet did pay monetary claims to the state for environmental damage, the consent decree stated that none of Aerojet's payments under the decree were fines or penalties.<sup>346</sup>

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<sup>345</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 19.

<sup>346</sup> *Id.*, at 18-19.

The contracting officer required Aerojet to seek reimbursement from its insurers before submitting a claim to DOD. The contracting officer believed the FAR required Aerojet to pursue insurance recoveries before it could seek reimbursement from the government. Aerojet disagreed with the contracting officer's interpretation, believing DOD should have paid its claim, subject to a refund for insurance recoveries. However, Aerojet submitted insurance claims soon after the contamination was discovered. Because the insurance companies would not acknowledge its claim, Aerojet brought a declaratory judgment action against its insurers in 1986.<sup>347</sup> An important issue decided in the insurance action related to whether Aerojet's costs were covered damages under its general liability policies. The trial court, in 1988, in granting a motion for summary judgment, decided Aerojet's costs to defend itself were covered, but actual cleanup costs were not. However, Aerojet was successful in seeking an extraordinary writ to vacate the trial court's order that cleanup costs are not covered.<sup>348</sup> Subsequently, the California Supreme Court upheld the rule that cleanup costs are covered in a similar case involving FMC Corporation and its general liability insurers.<sup>349</sup> Aerojet then continued its suit to obtain reimbursement of its past and future cleanup costs. During the trial, Aerojet argued it did not knowingly contaminate the soil and groundwater, while the insurance companies argued Aerojet expected or intended for pollution to occur as a result of its disposal practices. Aerojet lost the lawsuit in January 1992. A jury found Aerojet should have

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<sup>347</sup> *Aerojet-General Corp. v. San Mateo County Superior Court (Cheshire & Companies)*, No. A042785.

<sup>348</sup> *See, Aerojet General Corp. v. San Mateo County Superior Court*, 211 Cal. App. 3d 216, 257 Cal. Rptr. 621, *recons. denied*, 211 Cal. App. 3d 216, 258 Cal. Rptr. 684 (Cal. App. 1st 1989).

<sup>349</sup> *AIU Insurance Co. v. Superior Court (FMC Corp.)*, 51 Cal. 3d 807, 799 P. 2d 1253, 274 Cal. Rptr. 820 (Cal. 1990).

expected its disposal practices to contaminate the site.<sup>350</sup> Aerojet has appealed the court's decision because the trial judge did not follow California law in applying a negligence standard to Aerojet's conduct and did not allow Aerojet to present evidence it was following standard disposal practices of the time.<sup>351</sup> Even though Aerojet has not recovered any cleanup costs from its insurers, the \$11 million it has obtained were for costs of defending suits brought by property owners adjacent to the Aerojet site,<sup>352</sup> and governmental suits brought against Aerojet regarding the environmental contamination. The insurance recoveries also include an additional \$5 million in interest payments.<sup>353</sup>

Air Force documents indicated to GAO that the contamination occurred while Aerojet worked on government contracts. Aerojet's initial claim indicated use of trichloroethylene pursuant to a military standard established in 1950. According to the Defense Plant Representative, DOD has accounted for over 80 percent of the business generated by Aerojet's Sacramento facility since it first opened in the 1950s. During the 1988-91 period GAO examined, DOD work comprised 84 percent of Aerojet's total sales of \$1.7 billion, and NASA accounted for another 9 percent.<sup>354</sup>

It is interesting, even though Aerojet's conduct related to the pollution was established as a permit violation, the specific facts of the case warranted reimbursement.

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<sup>350</sup> *Aerojet-General Corp. v. Transport Indemnity Ins. Co.*, No. 262425 (Cal. Super. Ct. San Mateo County, verdict Jan. 13, 1992).

<sup>351</sup> *See, Insurers Win Battle Over Cleanup Costs, Aerojet Announces Plans to Appeal Verdict*, FED. CONT. DAILY (BNA) (Jan. 16, 1992).

<sup>352</sup> *See, Mangini v. Aerojet-General Corp.*, 278 Cal. Rptr. 395, *vacated*, 281 Cal. Rptr. 827, *pet. for rev. granted*, 883 P.2d 387, 35 Cal. Rptr. 2d 269 (1994).

<sup>353</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 20.

<sup>354</sup> *Id.*, at 21.



This is in keeping with the cases interpreting reasonableness.<sup>355</sup> The draft cost principle would have summarily disallowed these costs.

## **ii. Boeing**

The Boeing Company's headquarters and major operations are in the Seattle, Washington area. From 1954 to 1977, Boeing used two commercial sites south of Seattle to dispose of hazardous wastes--Queen City Farms from 1954 to 1968 and Western Processing from 1964 to 1977. Western Processing covers about 13 acres in the Green River Valley, and Queen City Farms includes about 320 acres in a rural hilly area. Both sites were privately owned and operated and were licensed as waste facilities. They also received wastes from government agencies and many different businesses. In the early 1980s, EPA investigated both sites and found industrial wastes on the surface, as well as soil and groundwater contamination. Many of the wastes found at each site, such as trichloroethylene, phenol, cadmium and PCBs, were on the Superfund list of hazardous substances, and the site was placed on the NPL. EPA identified 44 PRPs for Queen City Farms and 363 for Western Processing. Responsible parties included owners, transport companies, and numerous organizations whose wastes were deposited at the sites. Boeing was the largest contributor of wastes at each site and assumed leadership to maximize participation of responsible parties and to negotiate cost-effective cleanups.<sup>356</sup>

EPA first inspected the Western Processing site to identify potential contamination in 1981. In 1983, EPA closed the site and removed some of the most hazardous surface materials to stabilize the site. Cleanup activities occurred in two phases beginning in

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<sup>355</sup> See, *supra*, pp. 35-39.

<sup>356</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 22-23.

1984. The phase I partial consent decree required surface cleanup, including removing structures, stored wastes, and some surface soil. Phase II subsurface treatment involved a pump-and-treat system to wash soils and extract and treat the groundwater. Construction of the treatment equipment was completed and treatment began in 1988. Treatment is expected to continue through the mid-to-late 1990s with site monitoring through at least 2025. EPA first inspected Queen City Farms in 1980. In 1985, EPA, Boeing, and Queen City Farms signed a consent order to implement an initial remedial measure to drain ponds, remove soil, and construct a groundwater diversion system and monitoring wells. Because subsequent monitoring showed hazardous substances could migrate off-site, in 1988 EPA ordered the responsible parties to develop additional remedial measures, including soil, surface water, and groundwater treatments. EPA issued its decision on the preferred treatment late in 1992. Proposed actions would take 2-3 years to implement; monitoring shall take place for 30 years.<sup>357</sup>

Boeing cleanup costs at the Western Processing site amounted to \$85.5 million as of the time of the GAO report in midyear 1992. On the basis of Boeing documents, GAO estimated additional cleanup costs of \$31.4 million, including about \$7 million for monitoring and maintenance after the cleanup. Cleanup for Queen City Farms totaled \$15.8 million as of midyear 1992. This included \$13.5 million in direct cleanup costs and \$2.3 million in overhead costs for monitoring, oversight, and legal services. Costs after 1992 are estimated at \$46.5 million to further contain the buried wastes, vent the capped areas, treat groundwater, and remove additional metal debris and contaminated soil.<sup>358</sup>

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<sup>357</sup> *Id.*, at 23-24.

<sup>358</sup> *Id.*, at 24-25.

Boeing allocates overhead, which includes the environmental cleanup costs, to its business segments and subsequently to commercial and government contracts. Of the \$101.3 million spent at the two sites as of midyear 1992, the federal government had reimbursed Boeing between \$11 million and \$13 million.<sup>359</sup> Boeing officials said most of this amount was paid by DOD because it has the largest share of Boeing's government business.<sup>360</sup> The relatively small federal share of total cleanup costs occurs because the government's share is based on its share of Boeing's operations and determined after Boeing receives reimbursements from other sources.<sup>361</sup>

DOD's Corporate ACO reported to GAO that the contracting officer initially, in 1985, questioned all Boeing's cleanup costs at the two sites. The contracting officer was concerned Boeing's costs might have been fines assessed by EPA, and be contingent in nature due to the uncertainty of the amount and whether insurance coverage applied. However, by 1987 the contracting officer had decided to recognize Boeing's cleanup costs for forward pricing and interim billing purposes. The contracting officer based his decision on three points: (1) Boeing did not violate federal, state, or local pollution laws

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<sup>359</sup> Boeing has estimated federal payments at \$11.1 million through June 1992 while DCAA estimated those payments at \$13 million for the 1984 through August 1992 period. The difference, according to DCAA, appears to be due primarily to assumptions about the mix of contract types. Local DCAA officials told GAO the actual amount of cleanup costs reimbursed by the government would require significant effort because of the way cleanup costs flow through Boeing's accounting systems and the large number of contracts and contract types.

<sup>360</sup> Note that Boeing's current DOD contracts included cleanup costs in the base for profit computation. However, G&A costs--environmental or otherwise--necessary to the overall operation of business have not been fee-bearing costs in defense procurements since 1987 when the present DOD profit policy was adopted. See, Defense FAR Supplement 215.971-2; see also, CIBINIC & NASH, *supra*, note 118, at 578 (1993).

<sup>361</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 25.

when it used the sites; (2) it appeared Boeing's general liability insurance would not cover the cleanup costs; and (3) Boeing incurred the cleanup costs as a result of environmental laws more stringent than those in effect at the time of contamination. To determine if Boeing violated then-existing laws and regulations, the contracting officer relied on information developed during extensive discussions with Boeing and information gathered by DCAA including: (1) a statement from Boeing it had not violated then-existing laws and regulations; (2) a report of the court-appointed special master who found no evidence of wrongdoing by Boeing or other site users; and (3) the 1986 consent decree for Western Processing, which stated the costs were not the result of fines or penalties. However, EPA activities at Western Processing and Queen City Farms did not include investigations for wrongdoing.<sup>362</sup>

Information developed in 1990 caused the contracting officer to reconsider the allowability of some cleanup costs. When Boeing sued its insurance companies in federal district court,<sup>363</sup> evidence was presented showing Boeing "expected or intended" pollution to occur at the Western Processing site in 1971, but nevertheless continued to use the site until 1977. As a result, Boeing did not have insurance coverage for a portion of cleanup costs at Western Processing. DCAA questioned whether Boeing's actions were prudent, since they put Boeing's insurance coverage at risk. Boeing disagreed with this position, stating it followed accepted practices and several other businesses and federal agencies also used the site during the period when pollution was occurring. The DCAA local office

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<sup>362</sup> *Id.*, at 25-26.

<sup>363</sup> *See generally, Boeing Co. v. Aetna Cas. & Sur. Co.*, 113 Wash. 2d 869, 784 P.2d 507 (Wash. 1990) (the question of whether CERCLA response costs were damages within the context of comprehensive general liability policy was certified to the state supreme court and answered affirmatively).

requested guidance regarding Boeing's negotiation of insurance settlements. Interim DCAA headquarters guidance stated the unreimbursed costs were allowable if: (1) Boeing acted reasonably in settling the costs, (2) the costs would have been allowable even if not covered by the policy, and (3) Boeing credits the government for insurance payments received. DCAA and the contracting officer concluded the Queen City Farms costs not reimbursed by insurance are acceptable for interim billings pending final determination. Because new policies that would include environmental cleanup costs are essentially nonexistent, DCAA believed Boeing might establish a self-insurance program. DCAA and the contracting officer are exploring allowability of such a program.<sup>364</sup>

Although DOD and Boeing agree hazardous wastes were a by-product of the manufacturing processes for government contracts, no records showed specific quantities of the wastes. Boeing produced major systems for the government during the 1955-77 period when Boeing sent wastes to Western Processing and Queen City Farms. For example, Boeing made airplanes for each military service, missiles for the Air Force, lunar orbiters and modular spacecraft for NASA, and a rapid transit system for the Department of Transportation. Boeing also produced hazardous waste from commercial operations, but no requirement existed at the time for a system to account for types and quantities of wastes generated. In 1988, DOD and Boeing agreed to apportion the allowable costs in proportion to the square footage dedicated to government business. According to GAO,

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<sup>364</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 26-27.

if Boeing's proportion of government business changes, then the government would pay another proportion of future costs.<sup>365</sup>

The government-to-commercial ratio distribution base (by square footage) for the indirect costs was selected from alternatives. The first draft of the environmental cost principle would have mandated some government/commercial sharing formula. The present draft does not address cost allocation--as FAR part 31 cost principles are intended to address cost allowability, not allocability. However, the option of such a formula as an equitable distribution base continues to be available.<sup>366</sup>

Other interesting points from the Boeing situation include the litigation necessary to determine insurance coverage, as was found also in the Aerojet study. The other of note is that the government reimbursement of Boeing's environmental cleanup costs was nowhere near full--rather around ten percent. Cost allowability is not synonymous with indemnification.

### iii. Lockheed

The Lockheed Corporation, headquartered in Calabasas, California, is involved in designing and producing missiles, satellites, and military aircraft. The Lockheed case study focuses on the company's Burbank, California facility. This COCO facility has been used to build such military aircraft as the U-2 high-altitude reconnaissance aircraft and the

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<sup>365</sup> *Id.*, at 27. Boeing and DOD more recently settled with EPA the cleanup of the Commencement Bay Superfund site in Tacoma, Washington. The EPA, Boeing and DOD consent decree was entered in the United States District Court in Tacoma on Jan. 31, 1995. Boeing's share was \$2.3 million; DOD is to pay \$7.7 million. DOD's liability is that of a named PRP. *Boeing, Defense to Pay \$10 Million to Settle Superfund Cleanup Costs*, FED. CONT. DAILY (BNA) (Feb. 14, 1995).

<sup>366</sup> See, CAS 418, *supra*, note 172.

F-117A stealth fighter. Lockheed is in the process of closing the facility, which, unlike other sites, is in a large metropolitan area.<sup>367</sup>

In late 1980, groundwater contamination was discovered in water supply wells in Burbank. The wells contained volatile organic compounds, primarily trichloroethylene and tetrachloroethylene. The concentrations of up to 1800 and 590 parts per billion, respectively, far exceeded the federal and state safe drinking water standard of 5 parts per billion. The city shut down its wells and obtained water from another water district. Studies identified numerous sources of contamination, including several on Lockheed's 425-acre aircraft manufacturing site in Burbank. California Regional Water Quality Control Board officials, however, attributed the contamination to industrial operations at Lockheed's site--including machinery degreasing, paint stripping, solvent distilling, and conditions such as leaking pipelines, storage tanks, and barrels. The contamination of Burbank's wells is part of overall pollution to the area. In June 1986, EPA placed the North Hollywood area of Los Angeles on the NPL.<sup>368</sup>

In 1984, Lockheed began site investigation, including drilling monitoring wells to find the sources of groundwater contamination and the extent of its migration off-site. Lockheed also constructed a groundwater treatment facility to help prevent the further off-site migration of the contamination. A feasibility study identified cleanup options in a 1989 EPA record of decision. EPA notified 34 PRPs, including Lockheed, of the cleanup method selected and their potential liability.<sup>369</sup> In March 1991, Lockheed and two other

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<sup>367</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 28.

<sup>368</sup> *Id.*

<sup>369</sup> *See, United States v. Lockheed*, D.C. Cal. No. CV91-4527MPR (Aug. 22, 1991).

PRPs--the city of Burbank and Weber Aircraft--accepted responsibility for the groundwater cleanup. They entered into a consent decree that covered the cleanup and financial obligations of each party. Under the decree, Lockheed was responsible to design and construct a groundwater treatment plant to be partially operational in 1994. Lockheed projected the plant would reach full operating capacity of 12,000 gallons of water per minute in 1998. The city of Burbank was to design and construct facilities to treat water and convey it to a blending facility. Weber Aircraft would contribute funds toward the design and construction of the groundwater treatment system. According to Lockheed, it was to have total responsibility to clean up soil contamination on-site. The Regional Water Quality Control Board, under its cooperative agreement with EPA, monitors the soil contamination cleanup at the Burbank site.<sup>370</sup>

Lockheed spent, as of May 1992, about \$9 million on preliminary cleanup. The activities included installing monitoring wells, conducting tests and analyses, drilling an extraction well, and constructing the groundwater treatment system. Final cleanup of Lockheed's Burbank site will be expensive and lengthy. Lockheed estimates its share of the cost to clean up soil and groundwater contamination to be around \$194 million. The city of Burbank and Weber Aircraft have agreed to contribute \$3.3 million and \$3.75 million, respectively. The cleanup is expected to be finished by the year 2000.<sup>371</sup>

As of July 1992, DOD had not reimbursed cleanup costs for the Burbank site. Lockheed would submit the first claim to DOD near the estimated cleanup cost of about \$9 million. Lockheed's cleanup costs could be reduced by other PRPs. As of the date of

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<sup>370</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 29-30.

<sup>371</sup> *Id.*, at 30.



the GAO report, EPA was negotiating with six other parties to determine their cleanup liabilities.<sup>372</sup>

The parties agreed to a Memorandum of Understanding ("MOU") that established the method to allocate cleanup costs to DOD.<sup>373</sup> DOD's share of cleanup costs will be charged to overhead as a G&A expense. The memorandum in effect allowed Lockheed to submit reimbursement claims, but reserved judgment on the allowability of the claim.<sup>374</sup> The DOD contracting officer approved the agreement based on EPA's consent decree, which did not discuss wrongdoing, and Lockheed's statement it complied with then-existing environmental laws and regulations. However, he did not independently investigate Lockheed's compliance with those laws and regulations.<sup>375</sup> A DOD spokesperson summarized the Department's thinking on this issue:

There is seldom any reason why the costs should not be allowable. That's a part of doing business. Our goal is to pay our fair share as far as cleaning up. It's not something that is isolated; major contractors have been doing this for a long time.

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The process of evaluating [whether to pay the costs] is done on a case-by-case basis of whether the cost is reasonable, the nature and the amount, whether or not the cost can be charged to a specific contract, and whether the cost is applicable to the contract in question.<sup>376</sup>

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<sup>372</sup> *Id.*

<sup>373</sup> See, *DOD to Pay [as much as] \$80 Million for Lockheed Cleanup of Contaminated Ground Water*, FED. CONT. DAILY (BNA) (Oct. 4, 1991).

<sup>374</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 31.

<sup>375</sup> *Id.*

<sup>376</sup> Corp. Crime. Rep. (Am. Com. & Publishing Co.) 7, 8 (Nov. 18, 1991); see also, *Efron & Engel, supra*, note 14, at 10.

What is particularly significant here is in the interest of DOD paying its "fair share" of cleanup costs, allowability apparently was determined without regard to whether Lockheed was acting lawfully or unlawfully when the pollution occurred--an analysis that would have been required under the latest version of the environmental cost principle.<sup>377</sup>

In April 1990, the Air Force Plant Representative Office raised concerns about the allocability of Lockheed's cleanup costs in the wake of Lockheed's decision to move the major division working at the Burbank site to Georgia. He expressed concern that increased indirect costs would be allocated to products manufactured by the remaining Lockheed Aeronautical Systems Company. Lockheed proposed another MOU that would allocate Burbank cleanup costs to all Lockheed business segments. In October 1990, the DOD contracting officer agreed to the memorandum after receiving guidance from DCMC. DCMC counsel stated the memorandum is consistent with applicable regulations and would favor DOD because DOD's share of cleanup costs would be lower by spreading the costs across the entire Lockheed company rather than just the segments located on the Burbank site. Lockheed's customer base is now about 70 percent government and 30 percent commercial. In comparison, over 90 percent of Lockheed's business at its Burbank site has been with DOD. From 1982 to 1991, out of \$14.2 billion total sales at Burbank, \$12.9 billion was to DOD. DCAA did not agree with the allocation methodology contained in the MOU. DCAA believed allocating the costs across all segments of the company is inconsistent with CAS. In an August 1991 memorandum, DCAA stated that the segment responsible for the contamination and/or those segments

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<sup>377</sup> See, Efron & Engel, *supra*, note 14, at 10.

still operating at the site should absorb the costs of cleanup because that would more fairly allocate costs.<sup>378</sup>

In contrast to the other cases, the contracting officer did not require Lockheed to pursue reimbursement from its insurers before submitting a claim for reimbursement to DOD. He stated to GAO that he intends to reduce Lockheed's claim for anticipated insurance recoveries as a credit under FAR 31.205-5. Lockheed believed its costs are covered damages and retained counsel to assist it in obtaining reimbursement. Lockheed met with its insurers in September 1992 to hold preliminary discussions on settlement of the issue. As of July 1992, DOD and Lockheed had not agreed on an insurance recovery rate for fiscal years 1991 through 1996 as included in DCAA's audit of Lockheed's corporate management expense forecast. Lockheed estimated it would not receive any insurance recoveries through fiscal years 1992, but would recover 10 percent of its costs in 1993 through 1996. DCAA questioned this estimate, stating the 1993 through 1996 recovery rate would be 75 percent. The contracting officer at Lockheed stated he would make a final decision regarding the recovery rate that would be used.<sup>379</sup>

The majority of the work done at Lockheed's Burbank facility has been for DOD. The government share of sales at the Burbank facility was generally about 90 percent, with virtually all of that being DOD. In addition, a GOCO facility operating between 1946 and 1973 was one of the major sources of contamination at the site. Lockheed said the contamination in Burbank occurred over a long time, possibly dating back to before World War II.

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<sup>378</sup> *Observations on Consistency of Reimbursements to DOD Contractors, supra*, note 145, at 31-32.

<sup>379</sup> *Id.*, at 32.

## **b. Legislative Activity**

About the same time the DCMC/DCAA joint study was announced, a hearing was held before the Legislative and National Security Subcommittee of the House Government Operations Committee on the issue of contractor reimbursement for environmental costs.<sup>380</sup> Testifying before the panel were witnesses from DOD, GAO, defense contractors, and environmental groups--each camp advocating a different position.<sup>381</sup> On one extreme, was the position that all environmental costs were allowable as ordinary and necessary business expenses.<sup>382</sup> At the other end of the spectrum came a bill introduced by Representative Carolyn Maloney (D-NY), which would have made unallowable all environmental costs at any COCO or other facility at which a contractor is liable in whole or in part for an environmental response action. The Maloney bill was referred to the House Armed Services Committee, but was not reported out of committee.<sup>383</sup> No consensus developed in the last Congress on what needed to be done about the allowability of environmental costs.<sup>384</sup> The National Security Subcommittee nevertheless stated its conviction a comprehensive cost principle was necessary.<sup>385</sup>

In congressional hearings and discussions with legislative staff, several concerns have been raised regarding a blanket allowability of environmental costs. Not surprisingly, the initial concern is cost. This is an era of budget retrenchment, and the quest by

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<sup>380</sup> See, *Reimbursement of Defense Contractors Environmental Cleanup Costs: Oversight Needed to Protect Taxpayers*, H.R. Rep. No. 103-408, 103d Cong., 2d Sess. (1993).

<sup>381</sup> For the various participants and positions, see, *DOD to Revisit Draft FAR Cost Principle, Will Reassess Government's Fair Share*, *supra*, note 312.

<sup>382</sup> See, *Id.*

<sup>383</sup> H.R. 3477, 103rd Congress, 1st Sess. (1993).

<sup>384</sup> See, McDonald & Isaacson II, *supra*, note 11, at 629.

<sup>385</sup> See, H.R. Rep. No. 103-408, *supra*, note 380.

contractors for government reimbursement presents yet another competing effort to obtain a portion of diminishing federal agency budgets. Another concern is the perception that there should be a connection between the contamination being remediated and a particular government contract. Without such a nexus, the argument goes, the government could be charged for "commercial" (non-government) contamination, or one federal agency could be paying for contamination caused by another agency's contracts.<sup>386</sup>

The subcommittee's report urged the Secretary of Defense to implement a system for identifying contractors' past and projected environmental cleanup costs. To implement that recommendation, Representative John Conyers (D-Mich), former chair of the Committee on Government Operations, attached an amendment to the fiscal 1994 defense authorizations act that requires DOD to submit an annual report to Congress detailing payments made to defense contractors for environmental response costs.<sup>387</sup> The provisions also required documentation of pending defense contractor requests for payment of environmental costs at any COCO or other facility at which the contractor is liable in whole or in part for the response action costs.<sup>388</sup>

## **2. 104th Congress**

With the upheaval in legislative leadership occasioned by the 1994 elections, little is yet known about the positions of many key decision-makers on this topic. However, enactment of pending legislation might moot the environmental cost principle or any successor, at least for the time being. First, H.R. 450, which the House passed February

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<sup>386</sup> See, McDonald & Isaacson II, *supra*, note 11, at 633.

<sup>387</sup> Pub. L. No. 103-160.

<sup>388</sup> See, *GovOps Urges FAR Cost Principle on Contractor Cleanup Costs*, 60 FED. CONT. REP. (BNA) 662 (1993).

24, 1995, would impose a six-month moratorium on most regulations promulgated after November 1994.<sup>389</sup> In addition, H.R. 1022 would require a risk-benefit analysis be conducted of some regulations, such as an environmental cost principle, to determine whether the risks merit the costs of a particular regulation. H.R. 1022 passed the House February 28, 1995.<sup>390</sup> In the Senate, a bipartisan bill supported by Senator J. Bennett Johnson (D-La) was introduced by Senate Majority Leader Robert Dole (R-Kan). That bill, which consolidated three other pending regulatory reform bills,<sup>391</sup> provides that federal agencies certify the benefits of their regulations justify the costs.<sup>392</sup> However, as part of the political compromise, agencies could consider non-pecuniary factors such as scientific, technical, or economic uncertainties and non-quantifiable benefits to health, safety, or the environment that might make a more expensive regulatory option appropriate.<sup>393</sup> Despite repeated attempts, a sufficient number of votes needed to force a final vote on the bill could not be found.<sup>394</sup>

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<sup>389</sup> See, *Spector Orders DAR Council to Reopen Environmental Cost Principle Case in Light of DCAA, DCMC Report*, *supra*, note 116.

<sup>390</sup> *Id.*

<sup>391</sup> S. 343, S. 291, and S. 333.

<sup>392</sup> See, *Senate Plans Bipartisan Regulatory Relief Bill*, 63 FED. CONT. REP. (BNA) 750 (1995).

<sup>393</sup> *Id.*

<sup>394</sup> Welch, *Defeat Looms for Regulatory Reform Bill*, USA Today, at A1, col. 2 (July 21, 1995); Dewar, *Dole Seeks Deal on Regulatory Overhaul*, The Washington Post, at A6, col. 1 (July 19, 1995).

## VI. RECOMMENDATIONS

The draft environmental cost principle has evoked considerable controversy, and has not failed for lack of opinions concerning its efficacy. The views of the many, including this author, sharpen the policy issues involved.

### A. Stated Policies

The present administration established a new position for environmental security that reports directly to the Undersecretary of Defense for Acquisition. That position, Deputy Under Secretary of Defense (Environmental Security), is held by Sherri Wasserman Goodman.<sup>395</sup> Perhaps the best statement of policy by the agency most responsible for the draft environmental cost principle comes from her testimony before the Government Operations Committee's Subcommittee on Legislation and National Security in May 1993. Ms. Wasserman Goodman stated:

If environmental damage occurred despite the exercise of due care by a contractor which complied with specific laws and regulations and conducted its business in accordance with standard industry practices, if that contractor has spent reasonable amounts in a cost-effective manner to remedy environmental damage, and if that contractor has vigorously sought reimbursement from all available contributory sources . . . it may be that the United States government should pay its fair share, but only its fair share of that contractor's costs.<sup>396</sup>

In her testimony, Ms. Wasserman Goodman referred to DOD's work on the draft cost principle several times. She characterized the draft cost principle as "consistent with

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<sup>395</sup> See, *Defense Department Reimbursement of Contractors' Environmental Cleanup Costs Before the Subcomm. on Legislation and National Security of the House Comm. on Government Operations*, 103d Cong., 1st Sess. 31 (1993) (Statement of Sherri Wasserman Goodman, Deputy Under Secretary of Defense (Environmental Security)).

<sup>396</sup> *Id.*

[existing] FAR cost principles," but did not characterize it as necessary.<sup>397</sup> In furtherance of achieving the stated goals, she stated:

Of course DOD does not want to reward a company by paying a share of its environmental cleanup costs if the company was negligent or did not comply with specific environmental laws or regulations; the government can use the FAR's reasonableness criteria to disallow costs that result from this type of behavior.<sup>398</sup>

Ms. Wasserman Goodman's prepared statement, referring to the "new approach to environmental security,"<sup>399</sup> advocated additional study to determine what is a "fair share."

The "new approach" is to include the following works in progress: data collection, consistent decision making on cost allowability issues, lessons learned, and regulations.<sup>400</sup>

Ms. Wasserman Goodman acknowledged several other significant points. She stated:

It is important to note that most industries treat environmental cleanup costs as an ordinary cost of doing business. For example, public utilities generally are permitted to include environmental compliance and cleanup costs in establishing their rates. Commercial companies include their environmental costs when establishing the prices of their goods and services, including those sold to the government.

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First, DOD awards most of its contracts competitively. The competitive process gives contractors the greatest incentive to minimize and to internalize environmental costs, and thus provides the maximum benefit to the taxpayer. In fiscal year 1992, about 67% of contract dollars were awarded competitively, and competition motivates contractors to operate as cost effectively as possible. Competitive contracts are awarded based either on lowest cost to the government or best value to the government, and generally without DOD analysis of individual elements of costs, such as overhead costs that include environmental cleanup expenses. DOD assumes, however, that subject to competitive forces, the products and services it

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<sup>397</sup> *Id.*

<sup>398</sup> *Id.*

<sup>399</sup> *Id.* Ms. Wasserman Goodman refers to this approach as C3p2--Cleanup, Compliance, Conservation, and Pollution Prevention.

<sup>400</sup> *Id.*



buys include a portion of contractor environmental costs--costs to comply with environmental laws and regulations, to prevent pollution, and to clean up.

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In its October 1992 report, the GAO examined case studies involving three defense contractors--Aerojet-General, Boeing, and Lockheed--for consistency in DOD's evaluation of environmental cleanup cost allowability. The GAO found that the DOD decisions on environmental cleanup cost allowability were inconsistent in these three cases. The implication was that the rendering of different reimbursement decisions was inappropriate, and was primarily the result of inadequate policy guidance. However, much of what was characterized as inconsistency by the GAO was, in fact, the result of contracting officers being confronted with differing fact situations at different points in the contract administration process.<sup>401</sup>

Although the degree of support for the draft environmental cost principle appears to have lessened, DOD's position stayed in keeping with that expressed earlier by Ms. Spector. She stated, "the Government should pay its fair share of environmental cleanup costs when the conditions set forth in the proposed cost principle are met."<sup>402</sup> However, it is significant the memorandum of explanation that accompanied the proposed principle neglected any mention of or allusion to "fairness." Instead, it disclosed that the cost principle was drafted to reduce the government's share of cleanup costs. It stated:

The proposed cost principle would . . . eliminat[e] . . . the uncertainty that currently exists as . . . [contracting officers] attempt to evaluate . . . [environmental] costs using the general allowability factors at FAR 31.201-2. The *Ad Hoc* Group believes that as a consequence, the budgetary impact of the proposed cost principle would be a reduction in allowable environmental costs.<sup>403</sup>

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<sup>401</sup> *Id.*

<sup>402</sup> See, Spector Policy Letter, *supra*, note 99.

<sup>403</sup> *Ad Hoc* Committee Memorandum, *supra*, note 279; see also, Efron & Engel, *supra*, note 14, at 7.

## B. Industry Comment

The government was not the only body to see a need for a cost principle to address environmental costs specifically. Before the text of the draft environmental cost principle was released publicly, the National Security Industrial Association ("NSIA") characterized existing regulatory coverage as "woefully inadequate" and urged a cost principle specifically allowing environmental costs.<sup>404</sup> NSIA recommended, at a minimum, such an environmental cost principle:

- (1) make clear that environmental costs, including those incurred to clean up contamination caused by past activities, are ordinary and necessary expenses of doing business and are therefore allowable contract costs;
- (2) distinguish between unallowable fines and penalties and allowable environmental costs;
- (3) distinguish between unallowable costs associated with legal proceedings and environmental costs incurred pursuant to judicial decisions or administrative rulings;
- (4) require the negotiation of advance agreements to insure equitable treatment of all parties when the usual methods of measuring costs, assigning them to cost accounting periods, and allocating them to cost objectives would produce inequitable results; and
- (5) require accrual-basis accounting for contract costing purposes.<sup>405</sup>

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<sup>404</sup> Interagency Subcommittee of National Security Industrial Association's Environmental Committee, White Paper: Barriers and Disincentives to Environmental Contracting (Dec. 2, 1991); see also, *NSIA Calls for Environmental Cost Principle, Indemnity for Cleanup Contractors*, 56 FED. CONT. REP. (BNA) 802 (1991).

<sup>405</sup> *NSIA Calls for Environmental Cost Principle, Indemnity for Cleanup Contractors*, *supra*, note 404; see also, *Endorsed Industry Position on Environmental Restoration Contractor Liability*, 57 FED. CONT. REP. (BNA) 862 (1992) (another white paper endorsed by 14 organizations, including NSIA, and 45 individual firms, concerning indemnity of cleanup contractors).

After the language of the draft cost principle was published, members of the private bar and industry consolidated their criticisms of the draft cost principle in the August 24, 1992 comments of the American Bar Association's Public Contract Law Section.<sup>406</sup> Besides submitting these 27-page comments to the Director of the DAR System and Chairman of CAAC, the section's chair later met with a FAR Council member on this issue--obtaining his concession that the FAR Council might re-examine the issue.<sup>407</sup> Generally, the ABA section's position was that the draft cost principle:

- (1) is inconsistent with the established legal framework governing both environmental costs and government contract cost allowability,
- (2) undermines contractors' attempts to mitigate their costs by recovering from third party sources, such as insurance; and
- (3) imposes an unfair burden on contractors and does not provide a feasible standard for determining the allowability of costs incurred in remedying conditions that current contractors did not cause.<sup>408</sup>

The ABA criticism focused heavily on the draft environmental cost principle's presumption that remediation costs were unallowable unless contractors could meet certain stringent criteria.<sup>409</sup> Also, the Section objected that the proposed cost principle sought to apply an imprecise fault-based standard, even though remedial costs were

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<sup>406</sup> See, ABA Comments, *supra*, note 131; see also, McDonald & Isaacson II, *supra*, note 11, at 628.

<sup>407</sup> See, Hopf, *ABA Section Members Meet to Discuss Environmental Cost Principle*, 58 FED. CONT. REP. (BNA) 392 (1992).

<sup>408</sup> See, ABA Comments, *supra*, note 131; see also, *Environmental Cost Principle Cleared for Issuance as Proposed Rule*, 58 Fed. Cont. Rep. (BNA) 184 (1992).

<sup>409</sup> One must ponder whether this focus would have been different if the cleanup costs provision was worded like the less controversial compliance costs provision; *i.e.*, that the costs would be *allowable if* conditions are met, opposed to *unallowable unless* conditions are met. The effect of both is the same.

incurred through the application of strict liability laws. Third, the rule would create burdensome (if not impractical) contract administration difficulties. Fourth, the draft environmental cost principle was littered with undefined, subjective criteria. For example, a contractor must have been "conducting its business prudently," and have "acted promptly to minimize the damage" of the contamination.<sup>410</sup>

The Public Contract Section listed the features it believed should be embodied in an environmental cost principle. Those features are:

- (1) An environmental cost principle should provide a clear and objective test for determining which costs will be considered presumptively unallowable.
- (2) The cost principle should enable contracting officers to rely upon the determination of the regulatory agencies with responsibility for and expertise in environmental matters.
- (3) Environmental costs should not be presumptively unallowable unless they arise from a violation of law.
- (4) A violation of law should not be deemed to have occurred unless a final and unappealable judicial or administrative order has been entered in an enforcement proceeding by a court or administrative agency having jurisdiction over the environmental matter.
- (5) An environmental cost principle should make clear that liability under CERCLA and other strict liability statutes does not constitute a violation of law.
- (6) Evaluation of the contractor's conduct should be made in accordance with standards applicable at the time the conduct occurred.
- (7) The culpability of a contractor's conduct should be measured at the managerial level within the corporate structure where responsibility for the contractor's policies and practices is placed.

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<sup>410</sup> See, ABA Comments, *supra*, note 131, *summarized in*, McDonald & Isaacson II, *supra*, note 11, at 628.

(8) The burden of proving allowability should be determined by whether there has been a finding of unlawful conduct. Thus the contractor should have the burden when a violation of law has occurred; the government should have the burden of proving improper conduct by the contractor when there has been no violation of law.<sup>411</sup>

Industry, like the government, has concerns for consistent treatment of environmental costs. Consistent with the draft cost principle, industry would have costs related to established violations of law be unallowable. However, it seems industry would prefer to make its case before an environmental forum than before the contracting officer, or-- more likely--have the contracting officer bound by anything less than a final judgment against a contractor. Such would result in presumed allowability in most instances--subject to reasonableness, of course.

### **C. Commentaries**

The draft environmental cost principle has drawn considerable comment in the trade press.<sup>412</sup> It is important to understand the points being made.

#### **1. Cons**

As a general matter, the draft environmental cost principle would prove unattractive to both contractors and policy-makers concerned with encouraging cooperation between the government and private concerns in environmental protection. Although the draft cost principle confirms prevention costs are allowable (unless they are incurred as a result of a contractor's violation of a law, regulation, or compliance agreement), imposing allowability criteria in addition to a reasonableness determination

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<sup>411</sup> See, ABA Comments, *supra*, note 131.

<sup>412</sup> To illustrate the points made, first examined are the criticisms of the draft cost principle made by Efron & Engel, *supra*, note 14. Then examined in the next section titled "Pros" are the counterpoints made in response by Karen Manos, *supra*, note 16.

makes recovery of cleanup costs difficult--indeed far more difficult than is their recovery under existing cost principles. This restrictive approach does not serve well either the contractors' interests or the national environmental restoration policy.<sup>413</sup>

Under the draft cost principle, the presumption of unallowability of cleanup costs can be overcome if a contractor affirmatively demonstrates several conditions. However, the burden on contractors would, at best, be very difficult to meet. Particularly troublesome is the condition that a contractor demonstrate it did not violate standard industry practices or then-existing environmental requirements when the condition requiring correction was created.<sup>414</sup>

Not only is this condition inconsistent with CERCLA--which imposes cleanup liability without regard to past conduct--it also would result in protracted disputes, which contracting officers likely would be unable to resolve short of extended fact-finding and litigation. For example, if the draft cost principle is adopted, a contractor and the government would have to be prepared to determine (a) when the pollution occurred, (b) how it occurred, (c) what the applicable laws (federal, state, and local) and other requirements were when the pollution occurred, (d) what the standard industry practice was when the pollution occurred, and (e) whether the contractor was complying with the environmental requirements and industry practices when the pollution occurred. Complicating the situation is the possibility that the pollution occurred over a long time during which industry standards and environmental requirements varied.<sup>415</sup>

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<sup>413</sup> See, Efron & Engel, *supra*, note 14, at 7.

<sup>414</sup> *Id.*, at 8.

<sup>415</sup> *Id.*

The practical consequence of implementing the cost principle is predictable. With little or no background in environmental law, contracting officers, followed by the boards of contract appeals and the Court of Federal Claims, would quickly find themselves rendering opinions on a wide range of very complex and esoteric federal, state, and local environmental requirements, as well as standard industry practices. Because a contractor's past behavior would be an issue, decision-makers would have to become expert in the history of environmental standards and acceptable industry practices. It is precisely the morass Congress sought to avoid by applying strict, joint, and several liability.<sup>416</sup>

To complicate things even further, if the environmental problem requiring correction occurred under the operation of a previous owner or user of the property, a contractor seeking to recover cleanup costs from the government would have to demonstrate the prior owner or user met then-applicable industry standards and environmental requirements. Because previous owners or users would have no stake in the cost allowability issue, they would have little incentive to help the contractor meet its burden. Therefore, it is likely this condition would pose an insurmountable hurdle for many contractors. This *de facto* bar to the allowability of cleanup costs would be fundamentally inconsistent with the strict liability environmental statutes that require current property owners to correct the environmental conditions even when they did not create them.<sup>417</sup>

Besides causing confusion and varying from existing cleanup statutes, the draft cost principle would not result in the government bearing a "fair share" of environmental

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<sup>416</sup> *Id.*

<sup>417</sup> *Id.*

cleanup costs, as DOD acknowledged was the government's obligation.<sup>418</sup> As a matter of fairness, the government should not be able to escape responsibility for a portion of the cleanup costs because of a contractor's, or a predecessor concern's, past technical violation of an environmental statute or regulation. Over the years, the government undoubtedly has saved a significant amount of money by having contractors perform to environmental standards that were then acceptable to the government. If the government can now defeat the allowability of cleanup costs by citing a higher standard of environmental awareness than it was demanding of the polluting activity at the time, it has raised "Monday-morning quarterbacking" to new heights. Unless a contractor caused pollution by a willful or deliberate action--not then known to or accepted by the government--the government should, in fairness, share in the costs of cleaning up that pollution.<sup>419</sup>

As a matter of public policy, the government should encourage contractors to preserve and restore the environment. DOD has acknowledged, "environmental cleanup . . . [is] one of the most pressing policy concerns of our time."<sup>420</sup> Any cost principle should reflect the tenet that, in today's climate, the costs associated with restoring and protecting the environment are necessary and ordinary costs of doing business. A cost principle that unnecessarily limits allowability of costs associated with environmental restoration would only discourage contractors from voluntarily undertaking steps that are in the national interest.<sup>421</sup>

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<sup>418</sup> See, Spector Policy Letter, *supra*, note 99.

<sup>419</sup> See, Efron & Engel, *supra*, note 14, at 8.

<sup>420</sup> See, Spector Policy Letter, *supra*, note 99.

<sup>421</sup> See, Efron & Engel, *supra*, note 14, at 9.



At the same time the government is emphasizing environmental protection and cleanup, its draft environmental cost principle is driven by an altogether different concern--"the budgetary impact."<sup>422</sup> To reflect accurately today's emphasis on the environment and to work within the statutes that govern environmental protection and restoration, a broader view must be taken. In other words, the government should encourage contractors to cooperate in pursuing the national policy of environmental protection by making protection and cleanup costs allowable, unless the costs were incurred combating pollution that resulted from a contractor's willful or deliberate actions. To impose retroactively a higher standard on contractors' past conduct--for example, one based on negligence or inadvertence, as contemplated by the draft cost principle--would unfairly ask more of contractors than the government asked of itself at the time the pollution occurred. In the end, it would undermine the restoration of the environment.<sup>423</sup>

## 2. Pros

The draft environmental cost principle is generally consistent with Ms. Spector's policy statement.<sup>424</sup> It makes costs of current compliance and prevention allowable, and makes costs of correcting environmental damage allowable when the contractor meets certain conditions--such as having complied with all then-existing environmental laws, regulations, permits, and compliance agreements.<sup>425</sup>

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<sup>422</sup> See, *Ad Hoc* Committee Memorandum, *supra*, note 279 ("the budgetary impact of the proposed cost principle would be a reduction in allowable environmental costs").

<sup>423</sup> See, Efron & Engel, *supra*, note 14, at 9.

<sup>424</sup> Spector Policy Letter, *supra*, note 99.

<sup>425</sup> See, Manos, *supra*, note 16, at 6.

Contractors do not face the daunting prospect of preserving and restoring the environment without direct federal contribution. While DOJ, as a policy matter, declines to initiate civil environmental enforcement actions against other federal agencies, DOJ's "unitary executive" theory does not entirely insulate federal agencies from liability. Recall that CERCLA expressly grants a right of contribution, even against the federal government.<sup>426</sup> Even absent contribution, PRPs against whom recovery actions are brought can, and often do, interplead other PRPs under Rule 14 of the Federal Rules of Civil Procedure. Hence, the government can be brought as a codefendant into an enforcement action by its contractors. Some defense contractors have pursued these options, even at COCO facilities--particularly in light of the decision of the United States District Court for the Eastern District of Pennsylvania finding the United States liable under CERCLA as an "operator," because the War Board supervised rayon manufacturing operations at the contractor's facility during World War II.<sup>427</sup>

Implementation of the draft environmental cost principle might result in contracting officers with little or no background in environmental law rendering opinions on a wide range of very complex and esoteric federal, state, and local environmental requirements, as well as standard industry practices. However, contracting officers already conduct that analysis under current FAR cost principles in determining whether costs of correcting environmental damage are allowable. However, they do so without the

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<sup>426</sup> *Supra*, note 31; *see also*, Manos, *supra*, note 16, at 4.

<sup>427</sup> *FMC v. United States Dept. of Commerce*, *supra*, note 34. *See also*, Wall St. J., at B8, col. 1 (Feb. 26, 1992) (reporting that lawyers representing Occidental Petroleum Corp. made similar arguments in their attempt to hold United States Army liable for CERCLA costs incurred in cleaning up New York's Love Canal, which was reportedly used for discarding rocket fuel during the 1940s and 1950s); *see also*, Manos, *supra*, note 16, at 4.

benefit of explicit factors applicable to environmental cases. Accordingly, the draft environmental cost principle might reduce disputes because it should remove the opportunity that exists under the current FAR costs principles for creative arguments about which factors are pertinent to the cost reasonableness determination in a dispute.<sup>428</sup> The protracted disputes and extended fact-finding the draft environmental cost principle purportedly would entail already occur under the current FAR cost principles.<sup>429</sup>

The draft environmental cost principle was not drafted with the single purpose of reducing the government's share of cleanup costs.<sup>430</sup> Rather, the intent is to "ensure contractor expenditures are consistently evaluated against an explicit set of rules."<sup>431</sup> Although the added consistency might as a consequence result in a reduction of allowable environmental costs, the new cost principle should not lead to results dramatically different from those under a proper application of current FAR cost principles-- particularly in the key areas of burden of proof, disputes, and allowability and reasonableness determinations.<sup>432</sup> Further, with the amount of money the government is spending to clean up its own sites, it is difficult to say it is not pulling its own weight. Fiscal responsibility is certainly as valid a concern for government policy-makers as protecting profits is for contractors.<sup>433</sup>

Compliance by federal agencies with the letter and spirit of environmental laws and regulations is a clear policy of the federal government. All major federal environmental

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<sup>428</sup> See, Manos, *supra*, note 16, at 7.

<sup>429</sup> See, *Id.*

<sup>430</sup> See, Efron & Engel, *supra*, note 14, at 7.

<sup>431</sup> See, Spector Policy Letter, *supra*, note 99.

<sup>432</sup> See, Manos, *supra*, note 16, at 6.

<sup>433</sup> See, *Id.*, at 4.

statutes contain express waivers of the government's sovereign immunity.<sup>434</sup> Moreover, DOJ is increasingly resorting to criminal prosecution of federal officials to enforce the congressional mandates of the federal environmental laws.<sup>435</sup>

### 3. Alternatives

Before closing, two alternative approaches offered as possible solutions are presented.<sup>436</sup> The first approach is based on the principles of compliance, risk, harm and pervasiveness.<sup>437</sup> The approach proposes specific alternative language:

(a) Environmental costs are those incurred by a contractor for:

(1) The primary purpose of preventing pollution, properly disposing of waste generated by business operations, complying with environmental laws and regulations, or

(2) Cleanup, remedial or corrective actions arising from the effects of past activities impacting the environment.

The above environmental costs shall include but not be limited to associated consulting, equipment purchase, investigative, monitoring, regulatory fees or oversight reimbursement, treatment, storage, transportation and disposal costs.

(b) Environmental costs under (a)(1) are allowable.

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<sup>434</sup> E.g., Clean Air Act § 118, 42 U.S.C. § 7418; Clean Water Act § 313, 33 U.S.C. § 1323; CERCLA § 120, 42 U.S.C. § 9620; RCRA § 6001, 42 U.S.C. § 6961; Safe Drinking Water Act § 1447, 42 U.S.C. § 300j-6; Toxic Substances Control Act § 20, 15 U.S.C. § 2619. *Accord*, E.O. 12088, "Federal Compliance with Pollution Control Standards," §§ 1-102, 1-103, 1-201, 43 Fed. Reg. 47707 (Oct. 13, 1978). *See also*, Donnelly & Van Ness, *The Warrior and the Druid: The DOD and Environmental Law*, 33 FED. BAR NEWS 37, 38 (1986).

<sup>435</sup> E.g., *US v. Dee*, 912 F.2d 741 (4th Cir. 1990), *cert. denied*, 499 U.S. 919, 111 S. Ct. 1307, 113 L. Ed. 2d 242 (1991); *see also*, Manos, *supra*, note 16, at 4.

<sup>436</sup> Interestingly, both solutions are presented by the same authors. Peter McDonald and Scott Isaacson wrote two articles concerning the draft cost principle. *See*, McDonald & Isaacson I, *supra*, note 87; McDonald & Isaacson II, *supra*, note 11.

<sup>437</sup> *See*, McDonald & Isaacson I, *supra*, note 87, at 855-858.

(c) Environmental costs under (a)(2) incurred to remedy environmental damage caused by past activities or inactivity, or for which a contractor has been judicially or administratively determined to be liable (including where a settlement or consent decree has been issued), are allowable except where:

(1) The environmental damage resulted from noncompliance with then existing laws and regulations;

(2) The contractor failed to exercise the proper degree of due care commensurate with the risk associated with the materials under its control; or

(3) The contractor failed to exercise the proper degree of due care commensurate with the harm or potential for harm regarding the materials under its control.

(d) Allowable environmental costs will be allocated in the ratio of contractor's commercial/government contract costs of using such regulated substances or materials during the same period.

(e) The contracting officer may disallow environmental costs otherwise allowable if he determines that the attendant facts and circumstances make such allowance unfair to the Government. Such a determination must be made by final decision and is subject to the Disputes clause (FAR 50.233-1).

(f) Costs incurred in legal or quasi-legal proceedings, and as a result of the outcome of such proceedings, are governed by 31.205-47 and 31.205-15, respectively.<sup>438</sup>

Paragraph (c)(1) embodies the principle of compliance. The language used is significant as the damage must have "resulted from" the noncompliance. Contractual violations of noncompliance not related to the environmental harm would not result in a disallowance of cleanup costs. Paragraph (c)(2) relates to the principle of risk. The "proper degree of care" is a standard that varies with the risks associated with the substances involved. This flexibility is necessary because of the widely disparate nature of

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McDonald & Isaacson I, *supra*, note 87, at 858-859.

contaminants and manufacturing operations. Paragraph (c)(3) also establishes a flexible standard ("proper degree of care") but for the actual or potential harm associated with the hazardous substances. This reflects the principle of harm. In this area, environmental expertise would have its greatest application. Paragraph (d) translates the principle of pervasiveness into an allocability rule. Essentially, agencies pay for the employment of hazardous substances to the extent they call for their use compared to other customers.<sup>439</sup>

The most singular feature of the proposal is its inherent presumption of allowability for all environmental costs and the need for a specific disputable determination by the contracting officer before such costs would be unallowable.<sup>440</sup> Though the suggested alternate language is well reasoned, it adds little more than a framework to make a reasonableness analysis. The outcome whether under the suggested language or existing cost principles should be the same. Allocability determined by a commercial/government ratio is a return to Round 1 of the drafts.<sup>441</sup> This departure from Cost Accounting Standards is necessarily an arbitrary one. It has no better logic than allocation on a causal or beneficial basis for indirect costs, or based on costs necessary to the overall operation of the business for G&A.<sup>442</sup> It also fails to account for an indeterminable source of contamination, or pollution cause by a previous owner of a contaminated property.

The second approach is less specific. This approach concedes the term "environmental costs" is not susceptible to precise definition. Environmental costs are

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<sup>439</sup> See, *Id.*, at 859.

<sup>440</sup> See, *Id.*

<sup>441</sup> See, *supra*, p. 23.

<sup>442</sup> See, *supra*, pp. 40-45.

frequently difficult to recognize, isolate and measure. Broad and overlapping categories include:

- (1) Compliance costs: These are non-remediation costs that are legally compelled to comply with federal, state or local environmental laws.
- (2) Preventive costs: These are non-remediation costs that are not legally compelled by federal, state or local laws, but which are incurred to monitor the quality of the environment.
- (3) Remediation costs: These are costs incurred for remediation activity itself. These costs might be allowable if there are no administrative and/or criminal fines or penalties arising from the contamination for which the remediation costs are incurred.
- (4) Fines, penalties, and associated legal costs: These are administrative and/or criminal fines and penalties imposed by a federal, state or local jurisdiction for a violation of law. These costs, as well as legal costs arising from such fines and penalties, are unallowable.<sup>443</sup>

The common thread among the first three categories is that costs might be incurred without any wrongdoing by the contractor. All of these costs would be typically legitimate expenditures for a reasonable and prudent business, as well as enhancing public health and welfare. All such costs should be allowable unless incurred as a result of violation of law.<sup>444</sup>

In considering the allowability of compliance costs (even for a convicted polluter), note that the affected contractor does not have discretion regarding these expenditures.

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<sup>443</sup> McDonald & Isaacson II, *supra*, note 11, at 634.

<sup>444</sup> See, *Id.*

The costs are typically not individualized and punitive, but rather the result of legal requirements of broad applicability.<sup>445</sup> In addition, allowability is consistent with the treatment accorded similar compliance costs in areas such as safety (*e.g.*, OSHA), pertinent fire codes, and so on.<sup>446</sup> Preventive costs are not legally compelled, but they do promote the public health and welfare by protecting the environment in which the contractor's business is conducted. This second approach would allow these costs also.<sup>447</sup>

Remediation costs generally should be allowed. There should be no nexus between the remediation costs for which reimbursement is sought, and conduct for which the contractor has been assessed any administrative and/or criminal penalties by any federal, state or local jurisdiction. This provides an easily applied, objective test for contracting officers to administer. Consequently, contracting officers need not engage in protracted and detailed fault-based analyses of contractor conduct to ascertain the allowability of its environmental costs. These determinations are left to the appropriate environmental enforcement authorities in the federal, state and local forums. Contracting officers simply take the position that such fault-based decisions are binding on their own determinations of a contractor's remediation cost allowability.<sup>448</sup>

As for fines, penalties and associated legal costs, these remain unallowable consistent with FAR 31.205-15 (fines, penalties and mischarging costs) and FAR 31.205-47 (costs related to legal and other proceedings).<sup>449</sup> Of course, contracting officers have inherent authority

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<sup>445</sup> Note that enforcement actions may include notices of violation and compliance orders which are particularized. *See, supra*, pp. 17-18.

<sup>446</sup> *See, McDonald & Isaacson I, supra*, note 87.

<sup>447</sup> *See, Id.*

<sup>448</sup> *See, Id.*

<sup>449</sup> *See, Id.*



to disallow costs in circumstances where the facts, taken as a whole, indicate payment would be unreasonable. This serves as a basis for cost disallowance in egregious cases.<sup>450</sup>

Also suggested is there be no requirement to connect the contamination being remediated and a particular government contract. This approach might indeed result in an agency paying for commercial contamination, or contamination that might have been caused by another agency's contracts. However, requiring allowability to be predicated on connection to a particular government contract is an impractical and unnecessary requirement. Amalgamating remediation costs, regardless of source, is consistent with the commercial realities of pricing goods and services.<sup>451</sup>

This simplistic and easily administered approach could be rephrased as, "except for costs addressed by the fines and penalties, legal and other proceedings, or other existing cost principles, all environmental costs are allowable." This approach best serves all affected parties. This is far from advocating that all environmental costs of contractors be paid by the government. However, those costs properly allocated to a cost objective as either a direct, indirect or G&A cost, not unallowable by reason of a cost principle now in existence, should be allowable if reasonable. The unavoidable case-by-case determination of reasonableness protects the government from inequitable cost reimbursement. The contractor would continue to have the burden of establishing reasonableness of incurred costs if questioned by the contracting officer.<sup>452</sup>

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<sup>450</sup> *See, Id.*

<sup>451</sup> *See, Id.*, at 634-5.

<sup>452</sup> *See, supra*, pp. 31-32.

## VII. CONCLUSION

This thesis has not focused on the myriad of environmental laws generating costs for government contractors. Compliance with such laws is not beyond the experience of government cost-reimbursement contracting. This thesis has not detailed the alternative to cost reimbursement; *i.e.*, a contribution action against the United States for cleanup costs. Potential contribution action remains an issue when the contamination is related to the performance of a government contract. At the center of this analysis is the efficacy of the draft environmental cost principle. The draft cost principle forced the consideration of the many prickly issues that must someday be resolved. The draft cost principle is unlikely to return in present form. It may be gone, but it should not be forgotten. The environmental cost issues will resurface. Future attempts to address these issues will benefit from the careful consideration of the latest draft environmental cost principle. The core questions to be answered are what would be the impact of the cost principle on the treatment of various environmental costs, and whether such impact is for the good.

Although the draft cost principle adds nothing to the rules that allow or disallow fines and penalties and legal and other proceedings costs, the summary answer to the first question is that the draft environmental cost principle would render more costs unallowable than the absence of the cost principle. If there is no proof the pollution occurred during, and from, the performance of a government contract, the cleanup costs would be disallowed--though necessary to the overall operation of the business and otherwise properly allocable to the contract. The same is true if the pollution occurred before the contractor bought property presently known to be contaminated. In either

event, costs would be disallowed unless the contractor has exhausted or is diligently pursuing sources of contribution.

In the absence of the cost principle, these cleanup costs will be allocated the same as other costs, and allowed or not based on reasonableness. This approach is preferable to that of the draft cost principle. It allows contracting officers and contractors to negotiate the costs the draft cost principle would disallow. Despite the amount and variety of the environmental costs of the three major defense contractors examined by GAO, the costs were amenable to negotiation. Though existing cost principles require a case-by-case determination of allowability, as would the draft cost principle, existing law has not forced litigation to judgment.

The DCAA guidance, while not favoring the contractor as much as existing cost principles might suggest, is comprehensive. It provides the regulated community sufficient notice of how the government would view various costs. Further, the guidance is not law.<sup>453</sup> A contractor can take an issue of costs disallowed by a contracting officer following an auditor's recommendation to a court or board if necessary. In this manner, a body of law--not now in existence--would develop.

The perceived need for the cost principle stems from the unprecedented reach of CERCLA liability and the vast sums needed to clean up contamination. DOD's attempts to promulgate the draft environmental cost principle indeed appear to be founded on budgetary concerns. The latest draft of the cost principle is more restrictive than its immediate predecessor.<sup>454</sup> While the Director of Defense Procurement was making

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<sup>453</sup> See generally, *Cuneo v. Laird*, 338 F. Supp. 504 (D.D.C. 1972).

<sup>454</sup> See, pp. 27-29, *supra*.

statements the government was intending to pay its fair share of cleanup costs, she was also trying to achieve consensus on the cost principle among the military departments.<sup>455</sup> The objections of the Departments of Army and Navy that they could not withstand the impact of an earlier version of the cost principle became public only several months before the present draft was released.<sup>456</sup> Further, the *ad hoc* committee that drafted the language was unquestionably concerned about the budgetary impact of environmental costs, and stated the impact would be lessened by promulgation of the cost principle as they had worded it.<sup>457</sup> The military departments are certainly concerned with funding their needed programs. The vast, unpredictable costs being incurred by contractors threaten these programs. However, controlling program fund expenditures by disallowing reasonable, allocable costs seems parochial and short-sighted. Congress has allowed this agency fund-hoarding to flourish by not providing a mechanism to insulate austere program funds from cleanup costs necessitated by other government programs and agencies.

Unlike federal facility cleanups for which the government is directly responsible, reimbursement of the environmental costs of contractors is constrained by program budgets. Each dollar paid to a contractor for its environmental costs is one less dollar the program manager has to purchase goods or services under that program. Generally, costs to clean up a defense facility come from the Defense Environmental Restoration Account,<sup>458</sup> which is separately funded by Congress each year to pay for environmental

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<sup>455</sup> See, *Army, Navy Balk at Draft Environmental Cost Principle*, *supra*, note 107.

<sup>456</sup> *Id.*

<sup>457</sup> See, *Ad Hoc Committee Memorandum*, *supra*, note 279 ("the budgetary impact of the proposed cost principle would be a reduction in allowable environmental costs").

<sup>458</sup> The Defense Environmental Restoration Account is a central fund established by the Defense Environmental Restoration Program, 10 U.S.C. §§ 2701-08.

restoration of defense bases and facilities. A similar fund for reimbursement of allowable contractor environmental costs would be welcomed by agency program managers and contractors alike. For example, DOD may not be reticent to allow the costs to clean up contamination caused years before in performance of a Department of Energy contract. The last and present administrations have previously rescued its agencies and their contractors from the promulgation of the draft environmental cost principle through the regulatory moratoriums. It appears this Congress may eventually do the same. Congress can also cut to the source of the concerns that led to the draft environmental cost principle--agency budgets that would not support these costs--with a separately funded account from which program funds can be reimbursed for its contractors' reasonable, allocable and allowable environmental costs. If the nation's budget cannot withstand funding for this purpose, CERCLA reform<sup>459</sup> might be preferable to disallowing necessary costs of doing business.

Air Force Plant No. 44 is an active GOCO facility located in Tucson, Arizona. Hughes Missile Systems Company still holds the operating contract. The site has been on the NPL since 1985; its contaminants include trichloroethylene, chromium, and other metals found in the soil and groundwater.<sup>460</sup> About a year ago, the Air Force negotiated a lease with Hughes that replaced the facilities-use contracts that governed Hughes's operations at the Tucson plant since 1951. Under the lease, the government would

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<sup>459</sup> See, e.g., *Reform Outline "Unfair, Unworkable" in Some Areas, Browner Tells Senator*, 26 ENVTL. REP. (BNA) 560 (1995). A current proposal would eliminate CERCLA retroactive liability.

<sup>460</sup> *Inconsistent Sharing Arrangements May Increase Defense Costs*, *supra*, note 336, at 5.

continue funding remediation projects for contamination that occurred before the lease. However, according to the Air Force, the decision to fund the remediation has not determined ultimate liability for cleanup costs. The Air Force intends to seek contributions from the contractors that operated its facilities.<sup>461</sup> A 1987 Air Force Systems Command memorandum stated that Hughes was indemnified from responsibility for past groundwater contamination. However, further investigation by GAO revealed the operating contract between the Air Force and Hughes made no reference to Pub. L. 85-804 indemnification.<sup>462</sup> The Air Force now claims the 1987 document in no way was, or was intended to be, an indemnification of liability for future remediation costs occasioned by the groundwater contamination at the facility.<sup>463</sup> The lease between the Air Force and Hughes does contain a Pub. L. 85-804 indemnification clause. However, Air Force officials state the clause is not intended to grant relief for environmental cleanup.<sup>464</sup> Lastly, general and administrative costs, environmental or otherwise, necessary to the overall operation of business have not been fee-bearing costs in defense procurements since 1987 when the present DOD profit policy was adopted.<sup>465</sup>

Representative Synar asked for words to offer his constituents to explain the reason the Air Force was paying for the contamination at its Plant #44. If he was still in office and again had the opportunity to address them on this matter, perhaps he could say:

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<sup>461</sup> *Defense Indemnification for Contractor Operations, supra*, note 76, at 5-6.

<sup>462</sup> *See, supra*, note 76.

<sup>463</sup> *Defense Indemnification for Contractor Operations, supra*, note 76, at 5.

<sup>464</sup> *Id.*, at 6.

<sup>465</sup> *See*, Defense FAR Supplement 215.971-2; *see also*, CIBINIC & NASH, *supra*, note 118, at 578 (1993).

Mr. and Mrs. Smith, please understand neither you nor the companies our government does business with have ever faced the breadth or depth of the liability of our environmental cleanup laws. Environmental cleanup is a necessity. In order for us all to be winners in the long run, there shall be some short-term losers. Businesses such as yours are important to our economy. Businesses that receive awards for government contracts are also important to the economy. Further, the government depends upon these contractors as suppliers to the government. National security may even depend on a vital industrial base. Healthy contractors also apply the competitive force that enhances the quality and price of goods and services that satisfy government needs. We cannot force these contractors out of business or into loss positions unnecessarily.

Like you, the market may allow government contractors to pass along some cleanup costs to its customers, including the government. Let me assure you, however, cost-plus-percentage-of-cost (the more you spend, the more you make) contracts, have been prohibited for many years. Government contractors have restrictions on their accounting systems and methods of allocating various costs to government contracts, and rules by which allocated costs will be paid. Some reasonably incurred costs are paid, some are not. Costs incurred unreasonably are not paid. These rules also apply to environmental costs. You are not similarly restricted in including such costs in prices for goods and services you sell privately.

When all is said and done, the government is left to cleanup the environment at public expense if businesses close because of the burden of environmental cleanup--regardless of fault. We don't want that to happen to you, and we don't want that to happen to our suppliers either.